BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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

DIRECT TESTIMONY

OF

MICHAEL L. BROSCH

ON BEHALF OF PUBLIC COUNSEL, AARP AND WEBTEC

18 MARCH 2003

This document is the non-confidential version of this testimony pursuant to the Protective Order in this Docket.

TABLE OF CONTENTS
PREPARED TESTIMONY OF
MICHAEL L. BROSCH

Introduction and Qualifications

Q. Please state your name and business address.

A. My name is Michael L. Brosch. My business address is 740 North Blue Parkway, Suite 204, Lee's Summit, Missouri 64086.

Q. By whom are you employed?

A. I am a principal in the firm Utilitech, Inc., a consulting firm engaged primarily in utility rate and regulation work. The firm's business and my responsibilities are related to special services work for utility regulatory clients. These services include rate case reviews, cost of service analyses, jurisdictional and class cost allocations, financial studies, rate design analyses and focused investigations related to utility operations and ratemaking issues.

Q. On whose behalf are you appearing in this proceeding?

A. I am appearing on behalf of the Washington Attorney General – Public Counsel Section ("Public Counsel"), AARP (formerly the American Association of Retired Persons), and Washington Electronic Business & Telecommunications Coalition ("WeBTEC"). Utilitech entered into a contract with these parties, which I will collectively refer to as

"Consumers", to review and respond to the Application of Qwest Corporation ("Qwest" or "QC") for transfer and sale of the Qwest Dex, Inc. ("Dex") directory business.

Q. Will you summarize your educational background and professional experience in the field of utility regulation?

A. I graduated from the University of Missouri, Kansas City, in 1978 with a Bachelor of Business Administration Degree, majoring in accounting. I hold a CPA Certificate in the State of Missouri and in the State of Kansas. I am a member of the American Institute of Certified Public Accountants, the Missouri Society of Certified Public Accountants, and the Kansas Society of Certified Public Accountants. Since completion of formal education, my entire professional career has been dedicated to utility operations and regulation consulting.

From 1978 to 1981, I served as a public utility accountant with the Staff of the Missouri Public Service Commission. While employed by the Missouri Commission, I participated in rate case examinations involving electric, gas, water, steam, transit, and telephone utilities operating in Missouri. In December 1981, I accepted employment with Troupe Kehoe Whiteaker & Kent, a Kansas City CPA firm, in its public utility department. While with Troupe Kehoe Whiteaker & Kent, I was involved in the review, analysis, and presentation of a wide range of utility rate case issues and various other utility management advisory functions for both utility company and regulatory agency clients. In May 1983, I commenced employment with Lubow, McKay, Stevens and Lewis, an accounting and public utility consulting firm. While with that firm, I was involved in numerous regulatory proceedings and directed work related to various special projects.

In June 1985, Dittmer, Brosch and Associates, Inc. (now Utilitech, Inc.) was organized. The firm specializes in public utility regulatory and management consulting in the electric, gas, telecommunications, water, and waste water industries. As a principal of the firm, I am responsible for the supervision and conduct of the firm's various regulatory projects. A majority of the firm's business involves representation of utility commission staff and consumer advocate interveners in utility rate proceedings and special or focused investigations. In 1992, the firm was renamed Utilitech, Inc. to coincide with the admission of Mr. Steven Carver as a stockholder.

I have testified before utility regulatory agencies in Arizona, Arkansas, California, Florida, Hawaii, Illinois, Indiana, Iowa, Kansas, Michigan, Missouri, New Mexico, Ohio, Oklahoma, Utah, Washington and Wisconsin in regulatory proceedings involving electric, gas, telephone, water, sewer, transit, and steam utilities.

Q. Have you previously participated in Qwest or U S West Communications ("USWC") regulatory proceedings?

A. Yes. My firm has represented various clients in prior Qwest/USWC proceedings in several states. In Arizona, I participated in the last four Arizona general rate cases involving Qwest/USWC on behalf of the Arizona Corporation Commission Staff and supported the Staff in negotiating a Price Cap Plan in settlement of the most recent rate case.[1] In Washington, I assisted the Washington Attorney General's Office, Public Counsel Section, in negotiation and subsequent review of this State's Alternative Form of Regulation (AFOR) plan.[2] I was also a witness in the two subsequent Washington general rate cases involving USWC and in the 1998 Dex proceeding dealing exclusively with directory imputation issues.[3] In New Mexico, I served as a witness for the Commission Staff in the most recent USWC rate case.[4] In Utah, I served as witness for the Utah Committee of Consumer Services in USWC's last general rate case, Docket No. 97-049-08 and sponsored the directory imputation amount approved by the Commission in that Docket. I also represented consumer advocate clients in

1 ACC Docket Nos. E-1051-88-146, E-1051-91-004, E-1051-93-183, and E-1051B-99-105
2 WUTC Docket Nos. U-89-2698-F and U-89-3245-P
3 WUTC Docket Nos. UT-950200, UT-970766 and UT-980948.

Washington and two other states (Iowa and Utah) in the regulatory proceedings associated with the acquisition of USWC by Qwest.[5]

Q. What is the purpose of your testimony in this Docket?

A. My testimony is intended to describe and sponsor, on behalf of Consumers, certain conditions and ratemaking treatment that should be imposed if the sale of Dex is approved by the Commission. Under Qwest's proposed ratemaking treatment, the proposed sale of Dex is not in the public interest and should not be approved.

Q. Please summarize the recommendations that are set forth in your testimony.

A. The sale of Dex represents an extraordinary transaction intended to monetize and liquidate a major segment of Qwest's business that has historically been recognized above the line in establishing telephone service rates. Sale of the Dex income stream creates a substantial risk that the large gain on sale and cash proceeds from the transaction will be used to satisfy immediate creditor demands arising primarily from the non-regulated portions of Qwest's business, while the loss of the future income stream produced by directory publishing leaves the overall and regulated business financially weakened. In addition, the sale of Dex will frustrate future efforts of regulators to consider directory publishing income and cash flows in evaluating Qwest

4 PRC Case No. 3008.

Corporation financial results or revenue requirement. Further, it must be recognized that the sale of Dex yields a very large gain that should not be attributed largely to shareholders, as suggested in the Company's prefiled testimony. Prior orders of the Commission and the Washington State Supreme Court have recognized that directory imputation need not continue at the time the Company and its customers receive the fair value of the directory publishing asset.[6]

I recommend using the intrastate Washington portion of the realized gain on sale of Dex to secure a long-term annual revenue credit to replace existing imputation, so that no rate increases are required as a result of the Dex sale.[7] The excess of the Washington portion of the Dex gain, above what is needed to provide these annual revenue credits, should be directly bill-credited to customers upon closing of the Dex sale transaction. In addition, I recommend the Commission direct Qwest to continue its existing customer service guarantee program and service quality performance

5 Utah Docket No. 99-049-41, Iowa Case No. SPU-99-27, Washington Docket No. UT-991358.

6 The WUTC Second Supplemental Order in Docket No. U-86-156 listed three possible remedies it would consider: 1) approval of the contracts with an appropriate adjustment to the publishing fees- affirming that PNB retained the rights to publish the Yellow Pages; 2) return of the publishing function to PNB; and 3) treatment of the transaction as the sale of a capital asset. *See also* 134 Wn2d at 102; allowing the Company to, "apply for an end to imputation when it can show that it has received fair value for the asset" and WUTC Fourteenth Supplemental Order in Docket No. UT-980948 at paragraphs 159, 174 and 180.

7 The Washington assets and operations of Dex are to be sold in a transaction referred to as the "Rodney" agreement, while the eastern Qwest Dex states have already been closed in the corresponding "Dexter" transaction.

program through the end of 2006, removing the current opportunity for Qwest to petition in 2003 to end these programs at some earlier date.

The proposed long-term revenue credits will recognize that historically Dex has been treated as a regulatory asset in Washington and that ratepayers have a vested interest in the value associated with the directory business, while at the same time providing at closing near-term customer bill credits to mitigate the risks created by the sale of Dex. After the recommended one-time customer bill credits totaling $147 million are made, annual revenue credits in lieu of past directory imputation are fixed at $103.4 million per year for each of the next 20 years. The calculations supporting these recommendations are set forth in Confidential Exhibit MLB-2C and are explained in the "Gain on Sale Allocation to Washington" section of my testimony.

Q. How is the balance of your testimony organized?

A. My testimony is arranged by major topical area. A Table of Contents appearing at the beginning of the testimony sets forth this organization.

The Dex Sale Transaction

Q. Please describe the pending transaction to sell Qwest Dex.

A. Qwest Communications International, Inc. ("QCI"), the ultimate parent company owning Qwest Corporation, Qwest Dex and numerous other subsidiaries[8], has contracted to sell its entire interest in Qwest Dex, Inc. to a consortium of buyers including the Carlyle Partners III, CP III Coinvestment, L.P., and Welsh Carson, Anderson & Stowe IX, L.P. (hereinafter, "Buyer"). The sale of Dex is to occur in two stages, generally including the eastern portion of Qwest's local service territory in a "Dexter" transaction that has already closed, with a second stage "Rodney" transaction scheduled to close later in 2003. Consideration to be received by QCI is total cash of up to $7.05 billion, unless the Buyer requests QCI to retain an equity position of up to $217 million and/or provide debt financing to the Buyer not to exceed $300 million.

To transfer the Dex business as a going concern, numerous commercial agreements are incorporated into the Dexter and Rodney Purchase Agreements. These include a Publishing Agreement, a Directory List License Agreement, a Billing & Collection Agreement, a Noncompetition Agreement, a Trademark License Agreement and several other conveyance and service arrangement contracts. Collectively, these documents are intended to convey the entire Dex business to the Buyer in a manner that transfers the personnel, management, physical assets and automated systems, as

8 A highly summarized Qwest Corporate Structure chart appears as proposed Exhibit PCC-2 attached to the testimony

well as rights to use significant intangible assets of Qwest without disruption of the business or dilution of the considerable going concern value of Dex.

of Qwest witness Peter Cummings.

Q. Why is it appropriate to characterize the sale of Dex as an extraordinary event?

A. The proposed sale represents the liquidation of a major segment of the consolidated Qwest business, the directory publishing business that has historically been treated as a regulatory asset. The operating revenues, expenses and resulting income of this business segment have consistently been recognized within jurisdictional income for ratemaking purposes in Washington and other states, such as Utah. Never before has the directory publishing business of the incumbent local exchange carrier ("ILEC") in the Washington Qwest territory not been under common ownership and control with the ILEC. The sale of Dex was not reasonably foreseeable at the time of the Company's last rate case in Washington or before Qwest's financial liquidity concerns became acute in 2002. When the Company Petitioned for an Accounting Order, in Docket No. UT-980948, a hypothetical sale of Dex as of 1984 was postulated, but no complete sale of the directory publishing business enterprise has previously occurred.

Q. Isn't it true that the directory publishing business owned by Qwest and its predecessors has been transferred among affiliated entities in prior years?

A. Several internal reorganizations of the Qwest directory business have occurred in the past that are described in considerable detail in Section II. "History" portion of the Commission's Fourteenth Supplemental Order in Docket No. UT-980948 (Accounting

Order), that denied the Company's Petition for an Accounting Order. These limited scope transactions included the transfer of cash and certain directory assets into the new publishing affiliate as of January 1, 1984, the formation of U S West Communications and Media Group tracking stocks in 1996 with Dex being included as part of the Media Group, the 1998 spinoff of Media Group with Dex being purchased back by New U S West, and then the merger with Qwest in 2000. However, there has never before been a true sale of Dex to a non-affiliated entity reflecting an arm's-length transaction and valuation of the directory publishing business enterprise.[9] The pending sale of Dex therefore represents the extraordinary liquidation of a part of Qwest's Washington jurisdictional income stream that will no longer be available to support the Company's financial health or to contribute to its jurisdictional income for regulatory purposes.

Q. How was the Dex purchase price of $7.05 billion determined?

A. The purchase price was the result of negotiations between Qwest and the Buyers and appears to be reflective of the financial distress being experienced by Qwest as a

9 In its Fourteenth Supplemental Order in Docket No. UT-980948, at paragraph 187, the Commission concluded, "Imputation is merely a means to preserve the relative benefits of Yellow Pages operation to ratepayers and stockholders that existed prior to the Commission's authorization of the temporary transfer of the publishing function from PNB to Landmark in January 1984. Imputation also operates to reprice the ongoing affiliated transactions in an equitable manner. There is no evidence of an actual transfer from PNB or USWC to Landmark, and there has been no regulatory approval of any permanent divestiture of ownership of the publishing function from PNB or its successor, U S WEST Communications, Inc. The Commission denies

result of its debt burden and lack of liquidity to service its debts.[10] The negotiated $7.05 billion purchase price is (START CONFIDENTIAL) XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX. (END CONFIDENTIAL) I will explain the concerns with the purchase price later in the "Gain on Sale Allocation to Washington" section of my testimony.

Q. Even at the $7.05 billion price that you characterize as reflective of Qwest's financial distress, will the Company realize a large gain on sale that should be addressed by the Commission in this proceeding?

A. Yes. According to estimates prepared in the confidential response to Consumers Data Request ATG1-15S2 and Ms. Jensen's Exhibit TAJ-2C, the pretax gain on sale expected to result from the Dex sale is approximately (START CONFIDENTIAL) XXXXXXX (END CONFIDENTIAL). After consideration of income taxes and the various allocations required to determine a Washington share of this

---

USWC's petition for an accounting order ending imputation."

10 On December 23, 2002 Qwest announced a successful private debt exchange that will reduce total outstanding debt from approximately $24.5 billion to $22.6 billion and will extend some near-term maturities. In the Qwest Press Release announcing the debt exchange, the Company stated, "Over the past six months, Qwest's new leadership team has accomplished a number of steps to reduce debt and improve liquidity, including closing the sale of the first phase of its directory publishing business, QwestDex; amending the company's credit facility; and completing a new term loan."

gain, I believe that Washington customers are entitled to a present value net benefit of no less than (START CONFIDENTIAL) XXXXX (END CONFIDENTIAL) in after-tax dollars. The detailed calculation of this gain allocation is set forth in Confidential Exhibit MLB-2C attached to this testimony and is described in the "Gain on Sale Allocation to Washington" section of my testimony. The form in which Washington's share of this gain should be attributed to customers is discussed in the "Consumers Recommended Conditions Upon Approval" section of testimony.

Q. How does Qwest plan to utilize the cash proceeds from the sale of Dex?

A. The net cash realized from the Dex sale, to the extent not mandated for Qwest Corporation customers by order of regulators, is intended to be directed toward the repayment of debt. The Company restructured its debt around an amended and restated credit facility and term loan associated with the Dex sale transactions. Sections III and IV of Mr. Johnson's testimony and Section IV of Mr. Cummings' testimony describe the financial circumstances of the Company and the importance of the Dex sale in improving corporate liquidity. The recommendations contained herein give careful consideration to the Company's planned repayment of debt as well as customers' entitlement to participation in the realized gain associated with the sale of Dex.

Q. Will Qwest be required to pay income taxes on the gain it realizes from the sale of Dex?

A. Certain of the financial analyses prepared by Qwest's financial advisors in the transaction suggest that the (START CONFIDENTIAL) XXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XX (END CONFIDENTIAL) will offset the income tax liability otherwise payable on the Dex sale gain.[11] In response to Consumers Data Request ATG 4-74, the Company estimated its consolidated NOL carryforward position to be approximately $5.82 billion as of December 31, 2001. However, since Qwest Corporation's regulated ILEC business and the directory publishing business have been consistently profitable, such NOL income tax benefits arise from non-regulated business segments and should not be attributed to any gain considered for crediting to telephone customers.

Regarding income tax liability, the key point is that the sale of Dex creates an opportunity for QCI to realize a cash benefit for its NOL carryforward position and this cash flow benefit is being retained for shareholders because my

11 According to the Merrill Lynch Transaction Overview at page 2, provided in response to ATG 1-05 as Attachment B,

(START CONFIDENTIAL) XXXXXXXXX (END CONFIDENTIAL).

recommendations provide for income taxes at statutory tax rates as if the entire gain on sale is taxable and not offset by NOLs. Stated differently, the calculated income tax expenses allowed in Confidential Exhibit MLB-2C on the Dex sale gain will not be paid to the government, but will instead allow the parent company, Qwest Communications International, Inc. ("QCI"), to convert its NOL position into additional cash for use in repayment of debt.

Q. Would the Company be selling the Dex business if not for the poor financial performance of its non-regulated businesses?

A. No. As explained in the testimony of Qwest witness Ms. Jensen, "QCI was required to sell Dex as a critical component of its strategy to preserve and strengthen the financial integrity of QCI. Without the entire sale, bankruptcy is likely."[12]

Dex is a unique business enterprise encompassing the incumbent directory publishing position in the 14 states served by Qwest Corporation. Because of its position, Dex produces a consistently strong and growing stream of income and cash flow while requiring minimal capital expenditures. These characteristics are of sufficient value to yield over $7 billion in a distress sale of the business because the Buyers will enjoy this

12 Direct testimony of Theresa Jensen, page 9.

income stream upon sale of Dex. Unfortunately, QCI will sorely miss the income and cash flow produced by Dex after the sale, but the Company had little choice but to monetize this asset to meet the demands of its creditors.

Q. How do the commercial agreements that are incorporated into the Dex Purchase Agreement influence the value of the business?

A. The commercial agreements are required to convey the full value of the business to the Buyers because without such agreements Dex cannot function as a going concern in its present form. The new Publishing Agreement designates the Buyer as the "exclusive official publisher of all Directory Products" in the regions served by Qwest Corporation for the next 50 years, as well as a limited grant of "branding rights" to use the Dex names and marks and designation of the Buyer to receive all business referrals for directory advertising from within the Qwest Corporation region.[13] To preserve the public identity of the transferred business, a Trademark License Agreement grants the Buyer the right to use the "Qwest Dex" name in the conduct of the business.[14] Access to listings data, expanded use of listings, payphone placement rights, certain transition services and billing and collection services are provided for in other commercial agreements, which preserves the existing interfaces between Dex and the telephone

13 Exhibit D to the Rodney Purchase Agreement, Publishing Agreement at paragraph 4.2.

company.[15] Without these agreements, the value of the Dex business enterprise would be substantially diminished.

Q. Is there a completely new agreement associated with the Dex sale that did not exist previously, when Dex was a wholly-owned affiliate of the telephone company?

A. Yes. A new Non-Competition Agreement appears as Exhibit M to the Dex Purchase Agreement. The Noncompetition Agreement obligates Qwest and its subsidiaries to not "publish, market, sell or distribute any Directory Products" in competition with the Buyers interests for a period of forty years, as long as the Buyer performs in accordance with the terms of the Publishing Agreement.[16] This new Agreement has the effect of precluding Qwest and its telephone operating subsidiary from re-entering the directory publishing business to attempt a take back of the directory advertising profits typically earned by the incumbent telephone holding company. Notably, there was no need for a Noncompetition Agreement between Dex and its telephone operating affiliate prior to the transaction because the common parent entity was able to direct the telephone company to not compete with Dex.

---

14 Exhibit J to the Rodney Purchase Agreement, Trademark License Agreement, paragraph 2.1 and Appendix A.

15 See Exhibits E, F, I, K and G, respectively, to the Rodney Purchase Agreement.

16 Exhibit M, Noncompetition Agreement, paragraphs 2.1 and 6.3. This Agreement also provides for non-solicitation of

Q. How is the current proposed sale of Dex different from the 1984 transaction that created Dex's predecessor as a separate corporate entity?

A. The creation of U S West Direct in 1984 involved a non-arm's length transfer between corporate affiliates of employees, working capital and limited physical assets at book value, so as to move the directory publishing business outside of the telephone company (at that time Pacific Northwest Bell or "PNB"). There was no consideration given for the fair market value of the directory business enterprise in 1984 and there was no payment made to the telephone company or its customers for the fair value of the business or the considerable intangible assets associated with the directory business that were to be used by U S West Direct in the conduct of the business. Instead, for a limited period of time a publishing fee was paid by U S West Direct to Pacific Northwest Bell to partially compensate for the valuable official publishing rights, trade names and marks, incumbent publisher position and other benefits associated with affiliation with Pacific Northwest Bell. Later, these publishing fees were ceased by agreement to amend the publishing agreement between the telephone and publishing affiliates, to the extreme detriment of the telephone company, forcing regulators in Washington and other states to impute increasingly larger directory profits into the

employees and Dex senior management for a period of two years at Article 4.

telephone company income statement to correct for inappropriate compensation from the directory publishing affiliate.

In contrast to the contrived affiliate transactions in the 1980's, the pending Dex sale is a true sale of the directory business for a negotiated cash price determined through interaction of informed parties in possession of relevant valuation information. The $7.05 billion sale price (START CONFIDENTIAL) XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX[17] (END CONFIDENTIAL) and is based in large part upon the continued use of the official directory status of Qwest's directories in the new Publishing Agreement as well as the use of other Qwest intangible assets granted to the Buyer in the various commercial agreements. For the first time since the directory business was removed from the telephone company by affiliate transaction in 1983, regulators are now able to review a market valuation of the directory publishing rights associated with the incumbent local exchange telephone business and determine an appropriate regulatory treatment for the Dex transaction.

Q. What practical regulatory problems are created by the sale of Dex if it is approved by the Commission?

17 Confidential valuation summary pages from the Company's response to Data Request ATG 1-05, Attachments B and C, specifically the Dex valuation summary charts prepared by Merrill Lynch and Lehman Brothers, as presented to the Qwest Board of Directors August 19, 2002.

A. The current liquidity problems faced by QCI are mitigated in the short term by the Dex sale cash proceeds in amounts targeted to satisfy creditors. However, as noted in my testimony above, the substantial annual Dex income and free cash flows will no longer be available to QCI to meet ongoing capital requirements in the near and long term. The regulated telephone service business is inherently capital intensive, such that service quality is dependent upon continuing access to capital on reasonable terms. Absent an improvement in QCI operating and cash flow results beyond 2004, it is conceivable that the Dex sale represents only a temporary solution to more chronic problems impacting the Company's access to capital on reasonable terms. Therefore, one problem faced by the Commission is the continued weak and potentially worsening long-term financial condition of QCI after the Dex income stream is monetized.[18]

Another problem created by the pending Dex sale is the resulting absence of financial data for Dex in the event any future imputation calculation is needed by the Commission. In a "next" Washington rate case proceeding, the information required to calculate an imputation adjustment will no longer be controlled by a Qwest affiliate. Any

18 In the highly confidential response to ATG 1-71S3, the Company provided projections of its cash flow and cash balances after meeting debt service and after the sale of Dex and the results indicate (START CONFIDENTIAL) XXXXXXXXXXXXXXX (END CONFIDENTIAL).

financial reporting of earnings by Qwest or any evaluation of the Company's financial condition and traditional revenue requirement would be frustrated by the absence of any Dex financial data needed to update imputation. Therefore, a permanent resolution of issues surrounding ratepayer compensation for the directory publishing asset is needed in this proceeding.

Finally, the sale of Dex and the large gain on sale to be realized by QCI on the transaction requires regulatory attention because the Dex business represents a regulatory asset. If most of the gain on this extraordinary sale event is attributed to shareholders, as advocated by Qwest, customers of regulated telephone services will be denied equitable participation in the liquidation profits associated with a business that has historically been treated as a regulatory asset by regulators. The Washington share of the gain on sale should be attributed to ratepayers to offset the added risks borne by ratepayers if Dex is sold and to correct for embedded directory imputation values that are insufficient to fully recognize the Washington share of Dex sale gains. Shareholders should <u>not</u> be allowed to retain a large share of the gain on sale when they have not been "at risk" for the operations of the directory publishing business.

Q. Qwest witness Phil Grate argues that ratepayers have never borne any financial burden related to directory publishing, ratepayers bore a risk of loss for a maximum of 60 out of 120 years for tangible directory assets and

ratepayers never bore any risk of loss for directory goodwill. Are these arguments a reasonable basis to attribute a large share of the Dex gain on sale to shareholders?

A. No. The directory business of Qwest (and its predecessors) in Washington has consistently been operated in coordination with the regulated telephone operations under common ownership, so as to capture the tremendous economic benefits of publishing directories in conjunction with (and as an offset to the costs of) providing telephone services. Like the other regional Bell holding companies, directory publishing grew up within the telephone business because the Bell companies were recognized by advertisers as publishers of the most complete "official" directories in their territories. In the next section of my testimony, I will explain the synergies and linkages between the telephone company and the publisher of official directories for the telephone company that caused the Dex business to be treated as a regulatory asset. I will also respond to the specific claims of Ms. Jensen and Mr. Grate regarding these matters in the "Rebuttal to Qwest Witnesses" section of testimony. Ratepayers are entitled to far more than the 50 percent share of a diluted 71 percent allocation of the Washington gain that is proposed by Ms. Jensen.[19]

19 Direct Testimony of Theresa Jensen, page 34, and Exhibit TAJ-4C.

Dex Directory Publishing Is a Regulatory Utility Asset

Q. In your opinion, has the Washington portion of the directory publishing business operated by Qwest Dex and its predecessors been treated as a regulatory asset by the Commission?

A. Yes. The Washington portion of directory publishing has consistently been recognized within above-the-line intrastate earnings when the Commission has established a revenue requirement for the Company. As a result, the Company and its shareholders have not been at risk for Dex operating losses. Additionally, all of the incurred employee wages and benefits, other non-labor expenses and new capital investments associated with Dex have been allowed by the Commission when imputation was calculated in determining revenue requirements. Prior Washington Commission Orders are illuminating in this regard and are summarized in considerable detail in the "History" section of the Commission's Fourteenth Supplemental Order in Docket No. UT-980948 ("Accounting Order") that denied the Company's Petition for an Accounting Order to end directory imputation.

Q. In your references to the directory publishing business as a regulatory asset, do you mean to imply that any Dex regulatory assets were actually recorded on the telephone company's books?

A. No. This Commission has treated the entire directory publishing business in Washington as a regulatory asset, but has not required any regulatory asset accounting on the books of QC or its predecessors since the transfer of the business to the publishing affiliate. Instead, imputation was calculated for ratemaking purposes only to effect the regulatory treatment of Dex (and predecessors) as if the printed directory business was entirely jurisdictional and was not transferred.

Q. At page 5 of her testimony, Ms. Jensen references the WUTC Accounting Order and states that the Order, "…repeatedly states that PNB had transferred certain assets, but only temporarily outsourced the publishing function." Do you agree with Ms. Jensen's statement at page 6 that, "The Commission should issue an order that resolves the directory issue through the continuation of the existing directory earnings imputation until any ratepayers interest in the sale proceeds is satisfied …"?

A. I agree that the pending sale of Dex is a true sale of the directory publishing business enterprise that has previously been treated as an outsourced affiliate publishing function by the Commission. Because the affiliate publishing arrangement is to be discontinued and the directory publishing income stream is being sold to yield lump sum proceeds, I also agree that disposition of the gain on sale is now required to account for the liquidation of this regulatory asset. At page 46 of the Accounting Order in Docket No. UT-980948, the Commission provided for changes to directory imputation that may be required in stating:

> *179* The Commission will continue to use imputation to preserve and balance the positions of stockholders and ratepayers until the Company demonstrates a change in conditions that warrants a change in imputation.
>
> *180* The Commission will then have the opportunity to determine whether to end imputation and, if so, determine the appropriate disposition of any gain.

The sale of Dex fits squarely within these findings and provides the envisioned opportunity to replace imputation with a final disposition of value to customers for the lucrative official publishing rights controlled by Qwest. However, I do not agree with Ms. Jensen's and Mr. Grate's proposal to retain 65 percent of the Dex sale gain for QCI shareholders[20], given the fact that nearly 100 percent of Dex income in Washington has historically been subject to imputation. The Commission has not previously attributed large portions of the Dex business or its income stream to shareholders and there has been no fundamental change in the business since the Accounting Order was issued to justify this outcome. I will explain in more detail the

20 In her Confidential Exhibit TAJ-2C, Ms. Jensen removes all but 70.69 percent of the Dex Preliminary Gain Calculation. Then, at the top of Confidential Exhibit TAJ-4C, another 50 percent is extracted for shareholders before revenue credits to Washington customers are calculated. The combined effect of removing 29.31 percent plus half of the other 70.69 percent would

linkages between the directory business and the regulated ILEC operations of QC that support continued attribution of the value of the official publisher function to QC ratepayers.

Q. In your opinion, are the Dex directory operations still integrally linked to the provision of local phone services and properly considered a utility asset that is now being sold to the Buyer of Dex?

A. Yes. The linkages between the white and yellow page directories of Dex and the telephone services of Qwest Corporation continue to include:

1) Listings that represent the primary information content of the directories are created in operation of the local phone business. This makes the telephone company the best source for the most current and complete listings information. To advertise in the Dex yellow pages you must have business telephone service.[21]

2) Usage of the white and yellow pages is driven by telephone customers' desire to make more effective use of local telephone services to reach businesses they wish to communicate with.

3) The usefulness of local telephone service is enhanced by the availability of both alphabetical and classified directories.

4) In the case of Dex directories, much of the revenues earned from yellow pages advertising are billed on local phone bills of QC

---

attribute 64.65 percent of the overall after tax gain to shareholders.

21 Per Qwest web site description of Qwest Dex yellow page advertising. See http://www.qwest.com/pcat/large_business/product/1,1354,55_4_24,00.html

telephone customers and are collected and processed by QC remittance centers.

5) Qwest payphones, even though now deregulated, have been contracted to be provided with Dex directories.

6) Directories of Dex are published with prominent placement of identifying Qwest tradenames and trademarks linking them to the telephone company.

7) The public is likely to perceive Dex directories to be endorsed by the telephone company and thereby the "official" book that is accurate, current and comprehensive with respect to the phone number listings controlled and assigned by Qwest (see point 1).

8) Qwest refers customer inquiries regarding directory advertising to Dex, where such referrals may lead to incremental sales of advertising.

Simply stated, Dex publishes the "official" phone books for Qwest, and these directories offer significant value to advertisers as well as supra-competitive profits to the publisher. For all of these reasons, the traditional regulatory practice for many years, as codified in the FCC's Uniform System of Accounts and recognized by this Commission for many years, is to treat directory advertising and other directory publishing revenues as above-the-line for ratemaking purposes.

Q. Many of the linkages between the telephone company and the directory operations that you describe appear to represent intangible goodwill assets

enjoyed by the publisher from its relationship with the telephone company. Is this goodwill value recognized anywhere on the books of Dex or the telephone company?

A. No. Going concern or goodwill is not an investment that required contributions of cash or other assets by Qwest or QCI, but instead this value has arisen from doing business successfully over a period of time. For this reason, there are no recorded goodwill assets on the Dex or QC balance sheet associated with this value. In the pending transaction, $7.05 billion is being paid to acquire the Dex going concern business and its goodwill, and consistently large income stream. The origin of this goodwill and income stream arises from linkages into the telephone company that have existed for decades, linkages that are carefully preserved in the many commercial agreements that are made a part of the transaction.

Q. At page 14 of her Direct Testimony, Ms. Jensen states, "The tangible asset investment used to publish the directories was included in the company's regulated rate base. However, the company's regulated rate base did not include any amount for the goodwill of the directory advertising business, the right to publish directories for the telephone company or any other form of unrealized going concern value of the directory publishing operation." In

your opinion, does the pending sale of Dex involve the sale of goodwill associated with the directory publishing operations to which ratepayers have no claim?

A. The pending sale of Dex involves both tangible and intangible assets, but most of the value being conveyed has to do with the intangible assets associated with the long-term Publishing Agreement and Noncompetition Agreement in favor of the buyer that protect the income stream associated with publishing the official Qwest directories. These intangible assets, which Ms. Jensen has labeled "goodwill", have been created through operation of the publishing function that the Commission has already found to be a business asset retained by USWC for which continuing imputation is appropriate.[22] The entire directory publishing business, including both tangible and intangible assets and the earnings produced from such assets, has been treated as jurisdictional and includable in determining telephone revenue requirements. Thus, ratepayers have a continuing claim upon the value of the intangible goodwill assets related to the directory publishing function.

22 Accounting Order, paragraph 169, "We conclude that USWC retains the asset, both by the factual history of the transaction and as a matter of law. We will continue to regulate USWC as though it retains all rights to the asset. No complete transfer occurred in 1984, and we have no evidence of any later sale or other disposition to which PNB or USWC was a party."

Q. In footnote 4 of her testimony, Ms. Jensen asserts that “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." This argument is repeated at page 14 and in footnote 14 of her testimony and again repeated at page 21. Does this assertion support attributing any of the gain from the sale of Dex to shareholders?

A. No. The intangible, going concern value of the directory publishing business is what this Commission has recognized to be a regulatory asset for many years. This fact is acknowledged by Ms. Jensen at page 17 where she states, "In the Second Supplemental Order, Docket No. U-86-156, the commission treated Directory as a regulatory asset and determined that the public interest requires the full reasonable value of directory publishing be available to PNB for ratemaking purposes." Qwest is unable to show that its shareholders have incurred any significant directory publishing costs or have funded any of these "goodwill type assets" that need to be "recovered" or that should be allowed to earn a return in rate cases. The directory publishing goodwill that exists today arises from the official publisher position of Qwest and the development of publishing operations over many years and has already been found to be an asset retained by the regulated business. Prior to 1984, directory publishing costs were part of PNB's regulated operations where all incurred costs were recoverable through the ratemaking process. Since the publishing affiliate was established, all costs associated with directory publishing have been included for recovery in calculating imputation adjustments. Any “goodwill type assets” of Dex were created at no cost to shareholders and arise from the beneficial relationship and linkages between the official directory publisher and the ILEC.

On the other hand, the entire Washington share of Dex tangible assets has effectively been included in telephone company rate base because imputation has allowed a regulated rate of return on such directory publishing tangible assets. The imputation calculation was mathematically simplified by computing an excess return on directory assets that was to be imputed to the telephone company, but the same result would be achieved by including the Washington directory assets in telephone rate base and imputing all of the Washington directory income.

Q. Is the relationship between QC and Dex unique, or do the other three regional “Bell” holding companies also publish telephone directories that tend to be more profitable than the directory operations of non-ILECs?

A. According to information contained in a confidential Qwest Dex Strategy White Paper provided in response to Consumer Data Request No. ATG 2 -31, Attachment A at page 5, the Regional Bell Operating Companies (“RBOCs”) have very attractive revenue and

Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA") characteristics:

> (START CONFIDENTIAL) XXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXX
>
> XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXX (END CONFIDENTIAL).

These comments indicate RBOC market dominance and the distinctively higher earnings margins and cash flows realized by the incumbent local Bell company publishers, relative to the lower-margin competitors' financial performance. Such market dominance and financial performance among the RBOC publishers, relative to non-RBOC competitors, is indicative of the strategic advantages derived by linkages to the telephone operation and the benefits of official publisher status.

Q. Have Dex profits and cash flow trends continued to improve in the past few years?

A. Yes. According to the Dex Confidential Descriptive Memoranda prepared to describe the Dex business in soliciting bids from potential acquirers, the recent year's unaudited actual and projected Dex revenue and EBITDA values were as follows:

(START CONFIDENTIAL TABLE)

Confidential — Consolidated Dex Financial Information ($millions)

	1999	2000	2001	2002Est	2003Est	2004Est	2005Est	2006Est
Dex Total Revenues	XX	XX	XX	XX	XX	XX	XX	XX
EBITDA	XX	XX	XX	XX	XX	XX	XX	XX

Source: ATG 1-13, Attachment A, pages 36 and 48.

(END CONFIDENTIAL TABLE)

Q. Do the linkages between the telephone company and the publishing affiliate justify the continued attribution of virtually all of the value of the directory business to telephone ratepayers, even when the directory publishing business is sold?

A. Yes. Recognition of the excessive profits of the directory publishing affiliate has been necessary historically when setting rates because these profits are created from the unique benefits of affiliation with Qwest's telephone business, benefits that arise from and are integrally related to the provision of local telephone services. Upon sale of the Dex business, the ongoing earnings stream reflective of the linkages is to be transferred, but the Commission can now consider the fair market value of the directory operations business and determine the final one-time adjustment and any other conditions needed to properly attribute this value to ratepayers.

Q. Has this Commission previously attributed virtually all the directory publishing regulatory asset to customers, rather than sharing 50 percent or more of this asset with shareholders as suggested by Qwest witnesses?

A. Yes. All of the excess profits earned from directory publishing, above a regulated return on investment, have been imputed into telephone company revenues in Washington rate cases. There has been no carve-out of a ratepayer share of any return on goodwill or other assets by the Commission in its regulation of the publishing business.

Q. Earlier in your testimony, in describing the pending Dex sale transaction, you stated, "The commercial agreements are required to convey the full value of the business to the Buyers". Do the commercial agreements serve the purpose of preserving the linkages between Qwest Corporation's ILEC telephone business and the directory publishing business, after Dex is no longer an affiliate of Qwest Corporation?

A. Yes. The unique benefits of affiliation between QC and Dex, that were assured in the past through common corporate ownership and control, are now carefully formalized within the commercial agreements that are incorporated into the Dex sale contracts.

Q. How does the new Publishing Agreement between Dex Holdings L.L.C. and Qwest Corporation preserve the benefits of linkages between the regulated telephone company and the directory publisher?

A. The new Publishing Agreement designated the Buyer as Qwest Corporation's exclusive official publisher of all Directory Products in its region for a 50 year period, with certain Qwest Dex "branding rights" and a right to any referrals QC makes concerning directory advertising. (Exhibit D to Rodney Purchase Agreement at 4.2).

Q. Have the parties to the Dex sale agreements also made provision for the continued use of Qwest Dex intangible assets, so as to maintain the identity of the buyer as the "official publisher" of Qwest's directories?

A. Yes. The new Trademark License Agreement grants the Buyer the right for five years to use the "Qwest Dex" trademark on its products within the directory publishing service area, to provide continuity in the public identity of the business. (Exhibit J to Rodney Purchase Agreement at 2.1).

Q. Earlier in your testimony, you mentioned the new Non-Competition Agreement that was negotiated to protect the Buyer against Qwest Corporation's potential re-entry into the lucrative RBOC directory publishing business. How does this agreement work?

A. The new Non-Competition and Non-Solicitation Agreement serves to prevent Qwest from marketing, selling or distributing Directory Products in the Dex region in competition with the Buyer within the 40-year term of the Agreement. Qwest also agrees to not solicit for hire any employees or management transferred to the Buyer for a period of two years. (Exhibit M to Rodney Purchase Agreement at 3.1, 4).

Q. Is this Agreement intended to be binding upon Qwest Corporation ("QC"), the entity regulated by the Commission?

A. Yes. Qwest Corporation is listed as one of the "Qwest Parties" in the preamble of Exhibit M that are subject to the restrictions precluding in-region publishing of listings and advertising. However, even though QC surrenders its right to publish white and yellow pages directories in Washington and other local exchange areas it served for 40 years, Qwest Corporation will not receive any of the proceeds from the sale of Dex. The Non-Competition Agreement recognizes and eliminates the risk to the Buyer that

QC might choose to re-enter the directory publishing business as a formidable competitor because of the many advantages enjoyed by RBOC official directory publishers. This new Agreement transfers the publishing asset that has historically resided within Qwest to a non-affiliated entity for the first time in the Company's history.

Q. Has provision also been made within the commercial agreements between Buyer and Seller for a continuation of billing and collection services by QC, for the benefit of the new owner of Dex?

A. Yes. A new Billing and Collection Services Agreement allows the Buyer to receive billing and collection services from Qwest Corporation, services not received by any other directory publisher. (Exhibit G to Rodney Purchase Agreement) The linkage between the telephone company and the Dex business is reinforced by providing Dex advertising customers with a combined bill that also reflects the customer's Qwest Corporation telephone service charges. Creation of the combined end-user bill creates an accounts receivable balance for advertising as well as telecommunications services.[23]

23 Qwest Corporation has also agreed to (START CONFIDENTIAL) XXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXX (END CONFIDENTIAL) to the confidential Agreement for the Provision of Billing and Collection Services, identified as Exhibit G to the Rodney Purchase Agreement.

Q. Will Dex continue to be the supplier of directories for QC payphones throughout Washington and the other states served by QC?

A. Yes. A new Public Pay Stations Agreement provides for the continued placement of Dex directories within Qwest Corporation's payphones. (Exhibit I to Rodney Purchase Agreement) While Qwest payphones are no longer regulated, the placement of Dex directories with Qwest payphones supports public perceptions of the Dex directory as the official directory of the ILEC.

Q. You previously mentioned the extraordinary profitability and cash flow realized by RBOC-affiliate directory publishers like Dex. Will the Buyer of the Dex business receive and employ the human resources, automated systems, customer information and management personnel required to maintain business continuity and profitability?

A. Yes. Under the Rodney Purchase Agreement and the related Exhibit B Contribution Agreement, all of the existing tangible and intangible assets, allocated employees, designated management personnel and customer data of Dex that is related to the Rodney business will be transferred and sold to the Buyers. Thus, the Buyer receives the full going concern business at closing and is assured of no diminution of that value because of the protections built into the various other commercial agreements described above.

Q. After the Rodney Purchase Agreement and all of the incorporated commercial agreements are made effective, will the resulting complete and permanent liquidation of the Dex directory publishing business preclude any future consideration of the directory publishing business as a regulatory asset by the Commission?

A. Yes. QCI is left with only cash proceeds until applied to debt repayment, and with no further opportunity for its subsidiaries to publish directories on its own behalf.

Risks to Customers Created by the Sale of Dex

Q. What are the risks to customers and the regulatory issues that are created by the pending Dex sale?

A. The sale of Dex creates substantial new risks and issues to be addressed by the Commission:

- The liquidation of the directory business removes a large income stream that has historically been recognized by regulators to establish cost-based revenue requirements.

- The sale of Dex to a non-affiliated Buyer will cause regulators to lose access to directory publishing financial and operational information that is needed to evaluate telephone company financial performance and revenue requirement.

- Sale of the Dex income stream also substantially reduces the long-term ability of the Qwest consolidated businesses to generate cash flow from operations needed to service debt and attract capital on reasonable terms. Restricted access to capital may jeopardize the Company's ability to maintain high quality service.

- Sale of Dex provides a market valuation for the directory publishing regulatory asset and a corresponding gain on sale that must be attributed either to shareholders or ratepayers. Qwest's witnesses suggest that less than half of the gain should be attributed to telephone customers.

- Sale of Dex will cause the actual production and distribution of directories to be performed by a non-affiliated entity for the first time in Company history. The sale potentially reduces the Commission's ability to regulate Qwest's directory publishing obligation to customers because actual publication will be performed pursuant to contract with the Buyer, rather than by a corporate affiliate.

- Sale of Dex will likely increase corporate shared costs to be borne by QC because Dex will no longer be subject to an allocation of corporate overhead costs.

Q. Please explain the risks created when the directory business is no longer available for imputation in any future proceedings in which the Commission may be concerned with Qwest's Washington intrastate earnings and financial condition?

A. The future earnings and cash flows of Dex are being sold by Qwest to improve liquidity and satisfy the near-term demands of creditors. As a result, there will not be directory earnings to impute and no corporate accounting information from which to determine the profitability of the Dex business that continues to operate in Washington under new ownership. The sale of the income stream and the absence of Dex profitability data will expose customers to the risk that future imputation will be impossible to quantify or justify with factual data. For the first time in the Company's history, Dex is the subject of a true sales transaction that will permanently transfer all of the tangible property, employees, customers and specific intangible assets that are required to install the buyer as official publisher for the next 40 years.

Q. Why should Washington regulators care about access to Dex financial information?

A. In each recent Washington rate case, it has been necessary to review Dex financial information to determine the appropriate directory imputation adjustment. Access to Dex financial information is essential to accurately quantify the consistently increasing Washington directory publishing income in setting QC rates. Even if some form of incentive or price cap regulation is ultimately adopted that does not require periodic rate cases to change rates, the Commission must continue to monitor the financial performance, service quality and overall operations of the Company.

After Dex is sold to a non-affiliated buyer, there will no longer be assured regulatory access to directory publishing information, and the Commission will be left to guess what directory profits might have been if Dex had not been sold. The reported earnings of Qwest Corporation in the future will be chronically understated if the historically large and growing directory publishing imputation adjustment cannot be added into such earnings. For this reason, it is important to replace imputation with an appropriate alternative value in order to find the sale of Dex to be consistent with the public interest.

Q. Is the financial condition of Qwest Corporation and its parent QCI of vital importance to the Commission, even if price cap regulation is adopted at some point in the future in Washington?

A. Yes. The Company must continue to have access to capital on reasonable terms to provide high quality regulated services. A major segment of Qwest's business that has been extremely profitable for many years is being liquidated to satisfy creditors' repayment demands over the next few years. However, within the Company's own consolidated projections of cash flows and after the complete sale of Dex, QCI's ability to (START CONFIDENTIAL) XXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXX (END CONFIDENTIAL).[24] In a very real sense, the sale of Dex appears to be a corporate survival tactic that compromises the

24 See the Highly Confidential financial projections in Qwest's response to ATG 2-71S3.

long-term strength of the business in an attempt to increase liquidity and meet near-term debt repayment obligations. Qwest's significant financial problems were not caused by financial failures within the regulated business, yet a regulatory asset is being liquidated in an effort to remedy Qwest's liquidity crisis. Sale of the substantial Dex income and cash flow stream increases the risk that QC may compromise service quality or seek rate increases in Washington, particularly if the conditions recommended by Consumers are not ordered by the Commission.

Q. Do you agree with the testimony of Qwest witness Mr. Brian Johnson that the sale of Dex is important to the continued financial viability of QC and the parent company QCI?[25]

A. Yes. Mr. Johnson describes in some detail the deterioration in Qwest's consolidated financial performance, credit rating downgrades to junk status, accounting investigations and Qwest's resulting liquidity crisis. While it may have been possible for Qwest to sell assets or business segments other than Dex, issue new securities at extremely high cost, or reorganize the business through a merger, the sale of Dex was an attractive option for several reasons. Dex is an attractive business segment to sell because of its enviable market position, robust cash flows, and financial strength and

---

25 Brian G. Johnson Direct Testimony, page 2.

will therefore yield cash proceeds upon sale that are large enough to measurably improve Qwest's financial condition by reducing debt leverage. Notably, the Dex sale is larger, but similar to other directory sale transactions recently announced by Sprint, McLeod USA and Bell Canada to improve liquidity and access to capital markets.[26]

Q. Should the financial viability of Qwest and the desire of QCI to de-lever its balance sheet prevent the Commission from considering the interests of ratepayers in the Dex business and the proper distribution of the gain being realized from the sale?

A. No. In my opinion the interests of ratepayers in the Dex business are not subordinate to the interests of shareholders in preserving the gain and cash proceeds for corporate purposes. A reasonable attribution of the gain to Washington customers is necessary to secure existing imputation levels (or an economic substitute for such imputation) and ensure that the sale of Dex is consistent with the public interest. It remains possible that Qwest will not survive its liquidity crisis even with the sale of Dex. If a Qwest

26 Sprint agreed to sell its directory business to R.H. Donnelley Corp for $2.23 billion in cash, as announced in September 2002 (Dow Jones news release 9/22/2002). McLeodUSA Publishing was sold to U.K.-based Yell Group for $600 million in a deal announced in January 2002 (Kelsey Group Advisory, 1/23/2002). The Bell Canada Directories business was sold for $3 billion in cash (Canadian) to KKR and the Teachers' Merchant Bank in a deal announced in September 2002 (BCE Inc. News Release 9/13/2002).

bankruptcy eventually occurs, there may then be less of an opportunity to be sure that customers' interests in the Dex business are safeguarded.

Q. Does the Rodney Agreement explicitly recognize and provide for regulatory impacts that may be imposed by this Commission and by other state commissions?

A. Yes. At paragraph 5.4(b)(ii), the Rodney Agreement allows Qwest to not close the Rodney phase of the Dex sale in the event regulatory conditions imposed by states, including net revenue reductions or mandated incremental capital expenditures, become large enough to qualify as a "material regulatory impact" or "MRI". A separate "confidential letter of understanding" defines the MRI threshold to be $500 million.[27] Thus, Qwest can terminate its obligations under the Rodney agreement only if net economic losses from regulatory conditions reach this threshold value. Qwest's confidential Seller's Disclosure Schedule at Section 3.4 identifies (START CONFIDENTIAL) XXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

27 See MRI Side Letter captioned, "Confidential Letter of Understanding".

XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXX (END CONFIDENTIAL)

Q. Has Qwest assumed any MRI reduction will occur within its financial projections contained in the highly confidential response to ATG 1-71S3?

A. Yes. The maximum $500 million amount of MRI reduction to the cash proceeds from the Rodney transaction are assumed in the year 2003, when Rodney is projected to close. In addition, the projections also appear to assume that Qwest will provide $300 million of long term financing to the Buyers pursuant to the Rodney Agreement.[28] Thus, the cash proceeds ultimately available to the Company for debt repayment are uncertain, depending upon the magnitude of regulatory demands on behalf of ratepayers as well as the extent to which Qwest contributes seller financing to the transaction.

---

28 In its response to Data Request ATG 4-68, the Company stated, "The Buyer has orally informed Qwest that it will need up to $117 million of equity in addition to amounts committed by others in the Rodney Equity Financing Commitment Letter. Qwest has the option of funding that equity to ensure closure of the transaction. However, Qwest expects that the buyer will cover that amount itself or will arrange for other third parties to cover it…At this point, it is too early to speculate on a final result. Decisions relating to whether Qwest will ultimately contribute any equity will be made as the Rodney closing nears in 2003. Any shortfall in debt financing will be filled as the closing of the Rodney transaction gets closer in 2003. Qwest expects that Buyer will arrange to cover that shortfall, but a decision on the covering of any debt shortfall will be made next year as final financing arrangements are made."

Q. Please explain how the sale of Dex can be expected to increase corporate shared costs to be borne by QC.

A. Qwest incurs certain corporate overhead costs related to its corporate executive management, finance and accounting, treasury, human resources, marketing and other centralized administrative functions. These costs have historically been pooled and assigned or allocated across the various Qwest subsidiary operations, including QC and Dex, with Dex receiving a substantial portion of such charges.[29] Upon sale of Dex, for a limited transition period of 18 months after closing, some of these centralized corporation service functions will be provided to the Buyer pursuant to a Transitional Services Contract.[30] However, this contract may not fully offset the additional cost burden upon QC when Dex is no longer a corporate affiliate receiving a full allocated share of corporate administrative overhead costs. After the 18-month term of the Transition Services Agreement, corporate shared costs that cannot be reduced after Dex is sold will necessarily be absorbed by allocation across the remaining affiliates, including QC's regulated business. In an effort to evaluate this concern, the Consumers submitted Data Request ATG 2-30 asking for "a calculation of the expected annual impact upon Qwest Corporation's Washington-intrastate charges from affiliates as a

29 According to Qwest's confidential response to Data Request ATG 2-29S1, Attachment A, QSC headquarters cost allocations to Dex have ranged from (START CONFIDENTIAL) XXXXXXXXXXX (END CONFIDENTIAL) in the years 1999, 2000 and 2001, information technologies affiliate charges were more than (START CONFIDENTIAL) XXXXX (END

direct result of Qwest Dex being sold and no longer receiving its allocated share of such affiliate charges", to which the Company replied, "Qwest has not prepared the requested calculation. Preparation of the requested information would require a special study."

Beyond the effect of more narrowly allocated shared corporate costs, another cost increase to be imposed by the sale of Dex relates to the commitment by the Qwest parties to purchase on a take or pay basis at least (START CONFIDENTIAL) XXX XXXXX (END CONFIDENTIAL) per year in directory advertising from Dex for each of the next 15 years after the sale.[31]

Consumers Recommended Conditions Upon Approval

Q. What is your recommendation regarding the Dex transaction in Washington?

A. If not for the acute financial condition of Qwest and the possibility that selling Dex may allow the Company to survive its financial crisis, I would recommend that the Commission reject the sale of the directory publishing business. However, given the present economic circumstances of Qwest as well as the risks created by the

CONFIDENTIAL) in 2001, and significant other legal, property administration, and other affiliate charges were attributed to Dex.

30 Exhibit K to the Rodney/Dexter Purchase Agreements is a Transition Services Agreement.

transaction, I recommend approval of the Dex sale, subject to imposition of the following specific conditions by the Commission:

1) The Washington portion of the gain on sale to be realized by Qwest should be attributed entirely[32] to QC customers because the business enterprise being sold is a regulatory asset of the utility, as evidenced by the series of previous orders of the Commission addressing imputation.

2) The Washington share of the gain should first be used to provide $103.4 million per year of annual revenue credits in lieu of imputation for each of the next 20 years. A condition of sale approval should be the continued credit of this amount to telephone company revenues in all future financial reporting, earnings investigations and any revenue requirement calculations prepared for submission to the Commission. This condition will serve to prevent rate increases as a direct result of the sale of Dex for services subject to traditional rate regulation.

3) The remaining Washington share of the gain, after accounting for the annual revenue credits in item (2), is $147 million and should be flowed to QC's Washington customers on a one-time basis, through a customer bill credit that provides for broad-based attribution of the credit among customers.

4) To ensure that continuing QCI liquidity concerns after the sale of Dex do not contribute to declines in service quality in Washington, the Customer Service Guarantee Programs in tariff WN U-40, at 2.2.2(B) should remain in effect through at least December 2006 and the Service Quality Performance Program should be continued through at least December 2006.

These measures will ensure that Washington customers who buy services subject to earnings regulation are not adversely impacted by ceasing imputation and raising

31 This is referred to as the "Annual Ad Commitment" in Exhibit A to the Rodney Purchase Agreement.

32 Except for the minor allocations to non-publishing operations, such as LCI and New Ventures.

future rates, while also ensuring that the economic value of the Dex business enterprise is reasonably attributed to customers. Since most of the Washington share of the Dex gain on sale is retained by Qwest to provide future revenue credits in lieu of imputation, the vast majority of cash is immediately available to reduce corporate debt. The amount of one-time customer credits that could be characterized as a Material Regulatory Impact under this recommendation provides some additional compensation to customers to mitigate the risks arising from the transaction. The proposed extension of Washington service quality programs will serve to minimize the risks to service quality that may arise from Qwest's financial distress in the near-term.

Gain on Sale Allocation to Washington

Q. Was the Company asked to provide a calculation of the gain on sale anticipated to be realized from the Dex sale transaction?

A. Yes. Data Request ATG 1-15 requested information about the book and tax basis of the business interest to be sold and detailed calculations of the estimated book and tax gain on sale to be realized by QCI as a result of each (Dexter/Rodney) transaction with supporting workpaper calculations, assumptions, and underlying source documents. The Company provided a narrative response stating:

> An accurate estimation of the book and tax basis for the Dex business interest to be sold and the final sales price remains impracticable at this time. However, Qwest has now prepared a preliminary estimate of the gain on the sale of Dex and a computation of the portion of that estimated gain related to Washington. Qwest's preliminary estimate is provided in Confidential Attachment "A."
>
> The gain estimate assumes a sales price of $7.05 billion. The actual sales price will not be known until after computation of the Post-closing Working Capital Purchase Price Adjustment set out in Paragraph 2.9 of the Rodney Purchase Agreement and the Buyer's and Seller's agreement on that adjustment.
>
> This preliminary gain calculation relies on estimates of net book value and transaction costs. Neither the actual net book value at closing nor the actual transaction costs will be known until after closing.

I utilize the Company's estimated gain calculation on confidential "Attachment A" from this response as the starting point for information set forth in my Confidential Exhibit MLB-2C and have included each step of the Company's estimated Washington gain calculation (column C) for comparison to the Consumers' recommended calculations (column D). In this way, each disagreement or potential issue regarding the gain calculation and allocation to Washington is highlighted for consideration by the Commission. Ms. Jensen apparently utilized the same data from Attachment A to this response to prepare her Confidential Exhibit TAJ-2C.

Q. Did Qwest provide the estimated values shown at lines 1 through 4 of Confidential Exhibit MLB-2C in its response to Data Request ATG-15S2?

A. Yes. The sale price of $7.05 billion is the combined Dexter and Rodney price according to the Purchase Agreements, assuming no working capital adjustments are ultimately applied to this value. The (START CONFIDENTIAL) XXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXX (END CONFIDENTIAL) is approximately equal to the total assets of Dex Holdings as of December 31, 2001 and contains mostly current assets that will be subject to the purchase price true-up provisions referenced above.[33] The "transaction costs" subtracted from sale proceeds at line 3 include estimates of the total fees payable to investment bankers, legal and other advisory personnel involved in the transaction.[34] As noted in Confidential Exhibit MLB-2C, the Consumers have not challenged any of the Company's estimates regarding purchase price, contributed assets or transaction costs.

Q. Is the $7.05 billion purchase price negotiated between the Buyer and QCI representative of full, fair market value for the Dex business?

A. The increasingly urgent financial difficulties facing Qwest were widely known at the time the Company was soliciting interest in the purchase of the Dex business. In addition,

33 The Company's confidential response to Data Request ATG 1-02, Attachment B, provided restated financial statements for Qwest Dex Holdings, Inc. indicating total assets of (START CONFIDENTIAL) XXXX XXXX (END CONFIDENTIAL) at 12/31/2001.

34 In response to Consumer Data Request ATG 1-07S1, the Company itemized actual transaction costs payable through September 30, 2002 that totaled (START CONFIDENTIAL) XXXXXXX (END CONFIDENTIAL). However, large amounts payable pursuant to engagement letters with Lehman Brothers and Merrill Lynch are not due until closing.

the large size of the business and the Company's need for cash consideration tended to limit the number of potential buyers in a position to finance such a transaction. These factors detracted from Qwest's ability to get top dollar for Dex and (START CONFIDENTIAL) XXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX (END CONFIDENTIAL).[35] In the "fairness opinions" prepared for Qwest by Merrill, Lynch and Lehman Brothers, the $7.05 billion negotiated price for Dex is near (START CONFIDENTIAL) XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX (END CONFIDENTIAL). Nevertheless, to be conservative in my recommended ratemaking conditions for approval of the transaction, I have not contested or adjusted the $7.05 billion purchase price.

Q. At line 5 of Confidential Exhibit MLB-2C, you have reduced the Dex sale proceeds by almost (START CONFIDENTIAL) XXXXXXXXX (END CONFIDENTIAL) for income taxes at a 35 percent Federal income tax rate. Will QCI pay any income taxes on the Dex sale gain it experiences?

A. Probably not. As mentioned earlier in my testimony, QCI has accumulated large net operating loss ("NOL") carryforward balances for income tax purposes. In addition, the stock of LCI was included by Qwest in the assets being acquired by the purchaser for

35 Confidential response to Data Request ATG 1-05, Attachment A, page 7, (START CONFIDENTIAL) XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXX (END CONFIDENTIAL).

the apparent purpose of reducing income taxes otherwise payable on the transaction.[36] However, because the sources of negative consolidated taxable income in past years giving rise to the NOLs and the tax circumstances of the LCI entity are not related to the business operations of either the QC regulated telephone business or Dex, I have attributed Qwest's shelter from income taxes on the gain entirely to shareholders. There is no denying that the sale of Dex creates an opportunity for Qwest to realize these tax benefits as additional cash flow via tax savings, so shareholders are clearly advantaged by regulatory calculations (such as Confidential Exhibit MLB-2C) that attribute full statutory income tax rates to the Dex gain even though such income taxes will not be paid by the seller.

Q. Please explain the purpose for Lines 7 through 13 of Confidential Exhibit MLB-2C.

A. These lines disclose four allocations proposed by Qwest that would reduce the Dex sale gain to be attributed to the portion of the directory publishing business that has

36 Refer to the response to Data Request ATG 4-74 indicating Qwest's consolidated Federal NOL position at $5.82 billion as of 12/31/2001. In its response to ATG 7-109, Qwest stated, "The LCI business was also included in the Dex sale so that Qwest Communications International could report certain tax events on its consolidated federal income tax return form 1120 for the year 2002. One tax event was a tax loss realized on a separate return basis in the year 2000 for a Qwest affiliate other than Qwest DEX. The other tax event was the realization of the difference between the tax basis of LCI stock and the sales proceeds for the LCI stock on the Buyers' tax allocation statement."

historically been subject to regulatory jurisdiction or imputation. Specifically, the Company's confidential preliminary gain calculation that was provided in response to Data Request ATG-15S2 carves out portions of the sale price and resulting gain for attribution to the LCI entity being bundled into the sale, as well as Dex business operations that the Company has labeled: "New Ventures", Dex Secondary Directories, and Dex Primary Directories – Non Qwest listings. For each of these portions of the Dex sale, the Company would attribute the realized Dex sale gain to shareholders, rather than to the basic printed directory business that has been recognized in imputation calculations. Ms. Jensen explains the Company's rationale for attributing the gain on these portions of the Dex business to shareholders, rather than ratepayers, at pages 26 through 33 of her testimony.

Q. Does the LCI business have anything to do with directory publishing or Dex?

A. Aside from common ownership by Qwest, LCI has nothing to do with Dex or directory publishing. According to the response to Data Request ATG 4-73, "LCI International owns a limited partnership interest in Qwest N. Limited Partnership. Qwest N. Limited Partnership leases telecommunications equipment to Qwest Communications Corporation", which is the long distance and data networking subsidiary of QCI. Because it is unrelated to Dex and appears to have been bundled into the Dex sale transaction at Qwest's request to realize certain income tax advantages available to Qwest, I agree with the Company that the sale proceeds and gain amounts attributed to

LCI should be excluded from my calculations on Confidential Exhibit MLB-2C. However, as noted in Confidential Exhibit MLB-2C, (START CONFIDENTIAL) XXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX. (END CONFIDENTIAL)

Q. The next allocation of Dex sale proceeds and gain shown on Confidential Exhibit MLB-2C at line 9 is for an "Allocation to New Ventures". What is "New Ventures" and why is it excluded in allocating the Dex sale gain to the Washington jurisdiction?

A. As implied by the label, New Ventures is the portion of Dex that engages in non-traditional businesses such as internet directories, direct marketing services and other activities beyond directory publishing. Historically, these activities were not included within the core directory publishing division of Dex and were not included in calculation of imputation by regulators. Therefore, I concur with Qwest's calculation of the percentage of the estimated gain on sale of Dex that should be attributed to the New Ventures business. This percentage was based upon the relative revenues of the New Ventures activities to total Dex revenues and is likely to overstate the portion of Dex gain properly attributed to New Ventures because these non-traditional "ventures" are likely to be less profitable than the established publishing business. However, to be conservative in the Consumers' calculations in Confidential Exhibit MLB-2C and to reduce the number of issues in this proceeding, I accept the Company's revenue-based allocation to New Ventures.

Q. So far, in describing the line items in the Confidential Exhibit MLB-2C gain allocation schedule, nothing has been "at issue" in column E. However, when we get to the "Allocation to Secondary Directories" at line 10, you have completely rejected the Company's treatment. What are secondary directories?

A. Secondary directories are discretionary additional phone books produced by Dex within the QC territory to earn additional advertising revenues. Typically, they include regional and specialized directories, such as the "On-The-Go" directories for use with cellular telephones and in automobiles. In Washington, the Dex secondary directories include only two books, the Snohomish County regional directory and the On-The-Go directory for the greater Puget Sound area. These are additional discretionary books published by Dex that are marketed to advertising customers by addressing the value the advertiser receives, considering the circulation of the directories, the scope of the directories and the quality of the directories.[37]

Q. What is your understanding of the Company's rationale to allocate some of the gain on the Dex sale to its shareholders, rather than to Washington customers, because of the secondary directories that are published by Dex?

A. According to the response to Data Request ATG 6-85, "Secondary directories are published at Dex's discretion in order to compete more effectively in the advertising market and maximize advertising sales by providing directories that allow advertisers to focus their advertising message to a specific geographic scope which best represents their customer base." Ms. Jensen argues for shareholder retention of a "Secondary Directories" portion of the Dex gain on sale at page 28 as follows:

> Secondary directories are those directories that Dex publishes of its own accord, rather than through a contractual obligation with Qwest. These directories are published at Dex's discretion in order to compete more effectively in the advertising market and to maximize advertising sales by providing directories that allow advertisers to focus their advertising message to a specific geographic scope which best represents the advertisers' customer base. Secondary directories serve as a focused advertising medium for both consumers and advertisers. Secondary directories were not published when the directory operations were part of the regulated operations in Washington. In fact, Dex did not start publishing secondary directories in Washington until more than a decade after the Yellow Pages business was established as a separate

37 Direct Testimony of Theresa Jensen at page 29.

> subsidiary in 1984 [footnote omitted], therefore the portion of the gain attributable to secondary directories is not attributable to Washington regulated operations.

Q. Should secondary directories be excluded in allocating the Dex gain on sale to Washington?

A. No. Imputation in Washington was never limited to "Qwest listings in primary directories" or to only the specific activities the Company chose to include in its non-arm's length affiliate publishing contracts. Secondary directories represent additional products through which the directory publisher can prudently maximize revenues and profits, by scoping and publishing additional directories in targeted markets that do not conform strictly to telephone exchange areas. This is not a new or particularly innovative practice and is not unique to Dex. Prudent management is reasonably expected to seek growth opportunities in new markets and leverage recognized brand names like Qwest and U S West. Indeed, if the telephone company had remained in the directory publishing business after 1983, nothing would have precluded adding secondary book publications to maximize revenues, so as to reduce the net cost of providing telephone service.

Q. Has Dex incurred any significant costs or investment risks associated with publishing secondary books that have been attributed to shareholders by excluding such costs or investments in calculating imputation adjustments?

A. No. The entire directory publishing business of Dex (and predecessors) has been fully included in imputation calculations, including any incremental investments and expenses associated with developing and publishing secondary directories.

Q. At page 30 of her Direct Testimony, Ms. Jensen also argues for shareholder retention of Dex sale gain amount for what she characterizes as "non-Qwest listings". Is this the issue appearing at line 11 of Confidential Exhibit MLB-2C?

A. Yes. The Company seeks to retain a significant additional share of the gain to be realized upon the sale of Dex because its primary printed directories contain some listings that are not QC telephone company customers. Qwest proposes to carve out part of its directory revenues (and an equivalent share of the Dex sale gain) based upon the percentage of listings contained within its primary directories that are not Qwest telephone subscribers. For example, if the white pages listings in Seattle are determined to contain 80 percent QC customers and 20 percent customers who are served by competitive or independent local exchange carriers, the Company would attribute 20 percent of yellow pages advertising revenues (and the resulting Dex gain) to its shareholders. This proposed carve out, like Qwest's treatment of secondary directories, appears related to the Company's theory that imputation has been ordered only because the listings of telephone company subscribers appear within Qwest directories.

Q. Was imputation required by regulators solely because of the inclusion of telephone company listings within the published directories?

A. No. There are many linkages between the telephone company and the directory publishing operation, only one of which is the listing linkage. In my testimony above I explained the many bases for imputation and referred to the history of Washington Commission decisions on this matter. Imputation in Washington was required in order to continue the regulatory treatment of directory publishing as if that function had remained within the telephone company. There is no evidence that Qwest would not have published secondary books or included non-Qwest listings in its Washington primary directories if the publishing function had remained within the telephone company. Moreover, the QC publishing obligations described at pages 9 through 11 of Ms. Jensen's testimony would appear to require the inclusion of non-Qwest listings if the telephone company had retained an internal directory publishing function.

Q. Does Dex seek to include the listings of CLECs and independent telephone companies in its directories, without regard to any obligations that may require such inclusion?

A. Yes. Directory customers receive more "value" for their paid advertising in a more comprehensive directory that includes all relevant listings within a market area and that is distributed to more customers. Thus, it is simply good business to publish the most complete possible directories and in doing so Dex management is simply doing its job.

Q. Has Dex absorbed any added costs or risks in order to publish secondary directories or to include non-Qwest listings in its directories?

A. No. All of the costs of Dex's publishing operations have historically been included in calculating imputation. When imputation was last calculated in prior Washington rate cases, the Company did not remove or request the removal of revenues and income associated with Washington secondary directories or non-Qwest listings.[38] At that time, the Company was publishing the Greater Snohomish County secondary directory and also included numerous non-Qwest listings in its primary directories.[39] Therefore, Dex has not absorbed any additional costs or assumed any uncompensated risks by producing secondary directories or more complete primary directories that contain the

38 Qwest response to Data Request ATG 6-90S1.

customer listings of QC, CLECs and ILECs that provide telephone services within Dex directory market areas.

Q. What is the overall impact upon the Dex sale gain of the Company's proposed carve-out allocations to secondary directories and non-Qwest listings within primary directories published by Dex?

A. At line 12 of Confidential Exhibit MLB-2C, the cumulative difference in allocations indicates that Qwest's new proposals regarding secondary directories and non-Qwest listings would improperly remove approximately (START CONFIDENTIAL) XX percent (END CONFIDENTIAL) of the Dex sale gain for retention by shareholders. Across the 14-state QC service territory, this treatment would reduce the gain potentially attributable to customers by more than (START CONFIDENTIAL) XXXXXX (END CONFIDENTIAL) on a post-tax basis, as shown at line 14.

Q. Have shareholders been exposed to operating losses since 1996 (when imputation was last calculated in Washington) as a result of Dex efforts to expand publishing of secondary directories or from the inclusion of additional non-Qwest listings?

39 Qwest response to Data Request ATG 6-90S1, Attachments A and B.

A. (START CONFIDENTIAL) XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX (END CONFIDENTIAL) since imputation was last determined in Washington at the $85.2 million annual level.[40] Ms. Jensen has indicated at page 41 that the "current value of existing imputation" is $103.4 million. This is a strong indication of the sustained growth in directory revenues and income in Washington in spite of any incremental costs associated with secondary directories or the inclusion of non-Qwest listings.

Q. Why is the Washington percentage allocation proposed by the Consumers at line 15 of Confidential Exhibit MLB-2C somewhat higher than the percentage proposed by Qwest in its response to Data Request ATG 1-15S2?

A. The Company's proposed Washington allocation percentage is based upon the ratio of Washington directory revenues to total Dex directory revenues, <u>excluding secondary directories and non-Qwest listings</u>. However, since the Consumers oppose Qwest's exclusion of secondary directories and non-Qwest listings within primary directories, the Washington allocation percentage must be recalculated to maintain consistency using revenues from all directories. [41]

40 Direct Testimony of Theresa Jensen, page 34.

41 If the Commission agrees with the Company's proposed carve out of secondary directories and non-Qwest listings, the lower Washington percentage calculated by Qwest and shown in column C should be employed to maintain consistency.

Q. What is shown at line 16 of Confidential Exhibit MLB-2C?

A. Line 16 shows the Washington share of the anticipated Qwest Dex after-tax gain on sale, under the Company's allocation approach in column C, and as proposed by the Consumers in column D. Because these amounts are net of accrued income taxes (from line 5) it is necessary to factor-up to a pretax equivalent value for comparison to imputation revenues. This factor-up appears at lines 17 and 18.

Q. Is the amount shown at line 18 in column D the total Dex gain on sale amount properly attributed to the Washington jurisdiction?

A. Yes. This is the amount available, pursuant to the negotiated terms of the Dex sale transaction and after the allocations just described, to fund prospective revenue credits in lieu of imputation and other forms of benefit to Washington customers.

Q. At lines 19 through 40, you show a proposed Schedule of Customer Credits. What are these amounts intended to represent?

A. This Schedule of Customer Credits sets forth the pattern of initial and annual revenue credits recommended by Consumers to distribute the Washington gain to QC ratepayers. It consists of a one-time credit upon closing of the Rodney transaction and a series of annual amounts that would be used in all rate proceedings, financial analyses, earnings reviews and financial reporting of QC income to the Commission in the indicated years through 2023. These amounts are derived from the Washington share of the gain on line 16 that is accounted for as a regulatory liability in column E, subtracting the post-tax impact of the initial and annual customer credits and adding interest at 9.367 percent on the unamortized gain held by Qwest and not yet distributed to customers.[42]

Q. How does this proposed Schedule of Customer Credits compare with the Company's recommendations?

A. In her Revised Exhibit TAJ-4C, Ms. Jensen proposes revenue credits in lieu of imputation at approximately the same $103 million per year that I support, but for only about four and one-half years instead of the 20-year period shown in Exhibit MLB-2C. In the middle of year four, rate increases would be required to account for expiring customer revenue credits under the Company's proposal. Ms. Jensen also proposes no one-time credits in cash to customers. It appears that Ms. Jensen would apply a

42 The Authorized Weighted Cost of Capital in Docket No. UT-970766 was 9.367%. See Ms Jensen's Revised Exhibit TAJ-4C, page 2 where she translates this value into a "post-tax cost of capital" of 8.14497% that she applies to pretax unamortized gain balances.

somewhat lower interest rate than my proposed 9.367 percent rate to the unpaid ending balance of pretax amounts due ratepayers.[43]

Q. Why did you elect to use a twenty year period for continued revenue credits in lieu of imputation, rather than some other period?

A. It is difficult to predict how telecommunications services may be provided or regulated in the distant future. It is probable that continuing public policy initiatives and technological changes will eventually succeed at substituting competition for regulation of such services well within the next 15 or 20 years. However, in an abundance of caution, I elected to secure customer revenue credits for the full 20 year period. Washington has not terminated cost-based regulation, as have other price cap state jurisdictions, so there is a continuing opportunity in Washington to consider changes in revenue credits for ratemaking purposes.

Q. In addition to the $103 million annual revenue credit for 20 years, is there an additional amount available for a one-time crediting to Washington ratepayers?

43 See note 42.

A. Yes. The annual revenue credits I propose are conservatively quantified and are held constant for 20 years, leaving an additional amount for crediting to customers on a one-time basis.

Q. What amount of one-time credit to Washington ratepayers should be ordered as a condition of Dex sale approval in this Docket, after securing the embedded amount of imputation?

A. Line 20 of Confidential Exhibit MLB-2C reflects the remaining amount of the Washington share of the Dex gain, after providing for annual future revenue credits for 20 years. Thus, selection of the 20-year funding period to secure imputation results in an amount to be credited to Washington customers on a one-time basis in the amount of $147 million. I recommend this amount be credited to Washington customers as a one-time bill credit immediately after the Rodney transaction is closed.

Q. Why is a one-time credit to QC Washington customers for the residual Dex sale Washington gain amount appropriate?

A. As established in prior Commission Orders and explained earlier in my testimony, the Dex directory publishing business represents a regulatory utility asset and the sale of that asset is an extraordinary event that yields a gain that is properly attributed to customers. The Washington share of this gain should first be used to avoid future rate changes to remove embedded imputation, with the additional gain above this amount flowed to customers as a one-time credit.

Q. Is the percentage of Dex proceeds that you propose be credited to customers on a one-time basis a relatively minor amount of the overall anticipated Dex gain on sale?

A. Yes. The $147 million Washington one-time credit represents only about 2.1 percent of total Dex sale proceeds.

Q. Why are the customer credits proposed by Ms. Jensen in her Revised Exhibit TAJ-4C limited to only a little more than four years and so much lower in overall value to customers than the credits you propose?

A. The Company has recognized that ratepayers are entitled to participate in the Dex gain on sale. However, through a series of unreasonable allocations sponsored by Ms. Jensen and Mr. Grate, Qwest has seriously diluted the proposed ratepayer portion of the realized gain on sale of Dex, as follows:

(START CONFIDENTIAL TABLE)

Full Gain on Sale	100%

Less:	Allocation to New Ventures / LCI	XXXX (accepted)
	Allocation to Secondary Directories	XXXX (disputed)
	Allocation to Non-Qwest Listings	XXXX (disputed)
Sub-Total Allocable Gain per Qwest		70.7%
Less: 50/50 Sharing per Philip Grate		-35.35% (disputed)
Ratepayer Share of Gain per Qwest		**35.35%**

(END CONFIDENTIAL TABLE)

What is missing from the Company's analysis is any economic justification for the proposed crediting of almost two thirds of the Dex gain on sale to shareholders. I addressed the first three allocation issues proposed by Ms. Jensen in prior testimony and will respond to Mr. Grate's 50/50 sharing proposal in my Rebuttal to Qwest Witnesses section.

Q. Does the pending sale of Dex provide an opportunity to resolve directory imputation issues with some finality?

A. Yes. The sale of Dex provides a liquidating gain on sale value for the directory publishing business as well as an extraordinarily large cash payment for consideration by regulators. In my opinion, the Washington customers of QC are entitled to the pretax value shown at line 18 of Confidential Exhibit MLB-2C as of the date of closing the Rodney transaction. Fortunately, the extraordinarily large cash value for Dex that is being realized in the sale, in spite of the lower sale price caused by QCI's financial predicament, is sufficient to fund: 1) continued customer revenue credits sufficient to replace directory imputation for many future years, and; 2) a substantial immediate credit to customers to mitigate the risks arising from the transaction.

Q. How is it possible to secure revenue credits in lieu of imputation for 20 years and also credit customers $147 million on a one-time basis out of the realized gain from the sale of Dex?

A. Since the 1996 test year in which imputation was set at $85.2 million, there has been considerable growth in the directory publishing business. Historical Dex revenue and profit growth, as well as the prospects for continuing Dex growth, have driven the value of the business to more than $7 billion, even in a distressed sale environment. In addition, to narrow the issues in dispute at this time, I have accepted the $103.4 million annual revenue credit amount proposed by Ms. Jensen, even though considerably higher annual imputation would likely be justified in any future rate case.[44] Using Ms. Jensen's conservatively low annual revenue credit value leaves more of the Washington

44 The $103.37 million annual credit stated at page 19 of Ms. Jensen's testimony tends to undervalue imputation because it assumes the removal of profits from secondary directories and non-Qwest listings and because it is based upon calendar 2001 information. Any next Washington rate case would utilize current test period data inclusive of additional years of Dex revenue growth.

share of the gain for the one-time credit, so as to mitigate the near-term risks to ratepayers associated with the sale of Dex.

Q. Should the Commission be discouraged from imposing a one-time $147 million customer credit in Washington because the amount represents a large percentage of annual revenues earned by QC in the State?

A. No. QCI will realize the large gain from the sale of Dex within its income statement, but will not be recording a reasonable share of this gain within the Washington QC income statement. If the Washington share of the Dex gain were credited into the Washington books, the gain would more than offset an accounting accrual for the $147 million customer credit being proposed by the Consumers. The residual customer credit proposed by the Consumers should be thought of as funded by the parent entity that is realizing the large gain on sale associated with liquidation of Dex.

Q. Will the imposition of your proposed one-time customer credit in Washington, combined with reasonably expected regulatory impacts from the Arizona and Utah Commissions, where the Dex sale transaction is also under consideration, cause QCI to fail in its efforts to de-lever its balance sheet and improve its credit ratings?

A. No. In the Utah proceeding to consider the sale of Dex, the Public Service Commission approved the sale subject to continued imputation of revenues and a stipulated one-time customer credit of $22 million. In Arizona, regulatory conditions that may involve one-time customer bill credits from the Dex gain on sale are unknown, but may ultimately be much smaller than in Washington. If one combines the regulatory responses in other states to my recommendation in Washington, the vast majority of the Dex gain on sale and cash proceeds will be retained for shareholders and will be available to the Company to reduce outstanding debt. The parties to the transaction envisioned and provided for an acceptable level of regulatory retention or giveback to customers from the Dex gain and the proposed Washington customer credit requires less than 30 percent of the MRI allowance. However, even if the MRI threshold were exceeded, it is important that ratepayers' interests in Dex and the gain on sale not be compromised in an effort to provide incremental cash flow to support Qwest's debts that were incurred largely to grow its unprofitable non-regulated businesses. These debts may ultimately prove to be insurmountable problems if the health of the non-regulated businesses fails to dramatically improve.

Q. With respect to concerns about QC service quality or service availability deficiencies arising from Qwest's financial distress, what should be done to ensure that customers' interests are secured?

A. I have not developed any specific new service quality proposals, but recognize that expansion of existing programs may be desirable. My recommendation is that Qwest be required to continue the Customer Service Guarantee Programs as outlined in Qwest tariff WN U-40 at Section 2.2.2(B), and extend the current expiration date of the Service Quality Performance Program (that was initiated in connection with the Qwest merger in Docket No. UT-991358) so that these programs continue in their present form through the year 2006.

Rebuttal to Qwest Witnesses

Q. At pages 9 through 11 of her testimony, Ms. Jensen describes QC's directory publishing obligations under the Federal Telecommunications Act of 1996 and the Washington Commission's rules and explains how these specific obligations are met under the current and proposed directory publishing agreements. Has the existing affiliate publishing agreement between QC and Qwest Dex ever been found by the Commission to be reasonable in the way it compensates QC for the official publishing rights transferred to Dex?

A. No. The current and prior affiliate publishing agreements made effective between the directory publisher and the affiliate regulated telephone company have been consistently rejected and restated by the Commission via ratemaking imputation adjustments, because these agreements failed to fairly compensate the telephone company for the extraordinary value associated with the exclusive right granted the affiliate to publish QC's official directories. The new Publishing Agreement with the Buyer of Dex also provides no compensation to the telephone company for the valuable ILEC official publishing rights. The negotiated $7.05 billion price for Dex is largely reflective of this valuable official publishing right that is being purchased from QCI for cash and then being secured by a long-term non-competition agreement that prevents the ILEC from re-entering the directory business and eroding this value.

Q. At page 19 of her revised testimony, Ms. Jensen states, "QC is not asking to increase its rates <u>at this time</u> based upon the Dex sale. Therefore, the sale need not affect current levels of directory revenue imputation. Under QC's proposal, Washington ratepayers will continue to receive the current value of the existing imputation embedded in rates until the ratepayer interest in the sale proceeds is satisfied in year 2008" [emphasis added]. Will the interest of ratepayers in

the publishing asset be satisfied by maintaining imputation until only the year 2008?

A. No. Under the Company's proposal, customers will be harmed by the sale of Dex because of the potential for traditional rate increases starting in 2008, when the Company's proposed revenue credits would be exhausted. If Ms. Jensen's proposals are adopted, Qwest's shareholders would retain all of cash proceeds and most of the more than (START CONFIDENTIAL) XXXXX (END CONFIDENTIAL) in post-tax gain on sale (as shown at Exhibit MLB-2C, line 6), while ratepayers retain an imputation benefit for only the immediate future and are denied any potential future growth in the value of the publishing asset.

Q. At page 24, Ms. Jensen states, "The Commission should issue an order that continues imputation until the ratepayer interest in the sale proceeds is satisfied. The order should strike a balance among the interests of ratepayers, shareholders and the broader public that is fair, that preserves affordable, efficient, reliable service and that will not defeat the critical purpose of stabilizing QCI's financial condition." Do you agree with this approach?

A. I agree that continuation of directory related customer credits is important to avoid adverse customer impacts as a result of the sale of Dex. However, it will not be possible to "continue imputation", because the lack of access to financial information after Dex is sold will preclude updating for the continuing growth in directory revenues and income, and because the unreasonable affiliate publishing agreements that created a need for imputation will be terminated. Instead, what is needed at this time is a final accounting for the value of the directory regulatory asset and the provision of scheduled customer credits that recognize that the full reasonable value of directory publishing is to be made available for ratemaking purposes. The schedule of customer credits set forth in Exhibit MLB-2C achieves a balanced and fair accounting for the Dex gain on sale that reduces the cash available to QCI for debt repayment by only about 2.1 percent.[45]

Q. At page 26 of her testimony, Ms. Jensen asserts that ratepayers have a claim over only a portion of the sale proceeds and she quotes from the Accounting Order at paragraph 172 which states, "It revises USWC's earnings for regulatory purposes (that is, for setting rates), to reflect a *portion* [emphasis added] of affiliate U S WEST DEX's earnings." Did the Accounting Order or prior imputation orders issued by the Commission limit the claim of ratepayers in the manner proposed by Ms. Jensen?

45 $147 million one-time customer credits / ($7,050 million price, less estimated cash transaction costs)

A. No. The very small portions of Dex earnings that were not imputed into telephone company income fall into two categories. First, a regulated rate of return was allowed on the Washington share of Dex assets employed to publish directories, so as to effectively include such assets in rate base and recognize the capital costs incurred by Dex. Then, only the "excess" earned return of Dex, above this regulatory ROR, was subject to imputation. The only other portion of Dex earnings that were not imputed related to the operations of Marketing Resources Company, that is now referred to as the New Ventures/Internet line of business.[46] There was never any carve out of past Dex earnings imputation in Washington to exclude the Company's secondary directories or non-Qwest listings, as now proposed by Qwest's witnesses. Moreover, there is no precedent to share Dex excess earnings or the publishing asset associated with excess earnings on a 50/50 basis between shareholders and ratepayers, as is now proposed by Ms. Jensen and Mr. Grate.

Q. At page 32 of her testimony, Ms. Jensen claims, "Many of the "eyes" that now see the yellow pages advertisements are not Qwest subscribers, but are subscribers of independent LECs, CLECs, or wireless providers. To retain the consistent application of the attribution of value to local exchange subscribers

46 See page 28 of Direct Testimony of Theresa Jensen for discussion of MRC.

of the incumbent company, it is now necessary to apportion that value between Qwest and non-Qwest listings because many listings in the white pages are no longer Qwest listings. Second, the additional revenues that are earned by Dex as the result of Dex publishing ILEC listings and delivering directories to non-Qwest customers are not due to Qwest regulated operations or Qwest ratepayers and the gain from this portion of the business are not attributable to Washington regulated operations." Do you agree that the Commission must now apportion more of the value of Dex to shareholders for these reasons?

A. No. Imputation was never calculated in Washington based upon the makeup of the listings within the directories. There should be no impact upon Dex revenues caused when telephone customers change their carrier from ILEC to CLEC service – the same book goes to the same address and the advertiser reaches the same consuming audience. Ms. Jensen has not shown that any "additional revenues" are "earned by Dex" from publishing ILEC listings or by delivering books to non-Qwest customers. It has always been in the commercial interests of Dex to provide the most complete directories, delivered to the broadest group of customers, irrespective of what telephone company happens to serve the customers in the books.

Q. Turning to the Company's proposed 50/50 sharing of the 70.7 percent of Dex value not already attributed by Ms. Jensen to shareholders, her claim in testimony at page 34 is, "The vast majority of the gain on the sale of Dex is derived from the goodwill the business has built up over a period of more than 100 years of directory advertising sales. Ratepayers bore none of the cost of creating this goodwill and have borne none of the risk of loss of this goodwill. Hence, they are not entitled to the gain attributable to the goodwill of the business. However, in the interest of balancing ratepayer and shareholder interests, Qwest is proposing sharing 50% of all the gain - not distinguishing between the gain attributable to tangible assets, as opposed to goodwill - as set forth in Confidential Exhibit TAJ-4C." How do you respond?

A. Goodwill is both an accounting and legal concept. The goodwill that is referred to by Ms. Jensen is an accounting term used to describe the going concern value of the business above the fair value of its tangible assets. Mr. Grate provides another definition of goodwill at page 15 of his testimony from Black's Law Dictionary that includes, "patronage of any established trade or business; the benefit or advantage of having established a business and secured its patronage by the public." This is the same going concern or patronage value that the Commission has treated as a regulatory asset, because this value arose from the relationship between directory publishing and telephone service. From an accounting perspective, there simply was no "cost of creating this goodwill" as Ms. Jensen suggests – it arose from doing business for many decades as the incumbent telephone company and directory publisher. Notably, Ms. Jensen has not been able to quantify any of the suggested "cost of creating this goodwill" or prove that such costs were absorbed by shareholders.

With respect to any "risk of loss of this goodwill", the regulatory treatment of directory publishing has directly translated changes in Dex publishing revenues and income into corresponding changes in the amounts of imputation. Thus, ratepayers have been continuously "at risk" in the event of any loss of value associated with the publishing operation. The fact that a value for the regulatory publishing asset has now been negotiated at $7.05 billion, and this negotiated value is being allocated by Ms. Jensen and in my Exhibit MLB-2C, indicates that ratepayers will also absorb the risks of valuation changes experienced through the date the business is liquidated. It is disingenuous for Qwest to imply that the Dex publishing business has been developed at great risk and cost to shareholders, such that 65 percent of the gain on sale should now be attributed to shareholders.

Q. Mr. Grate also argues for 50/50 sharing of the Dex gain on sale (after Ms. Jensen's 30/70 allocation), stating at page 3, "I understand that to determine who should receive the gain on the sale of a utility asset, the Commission employs principles established in *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Transit Commission,* 458 F. 2d 786 (D.C. Cir. 1973), reh den, cert den, 415 US 935 (1973)", with footnote reference to the Avista Centralia WUTC decision. Did the Avista case involve the sale of directory publishing operations?

A. No. I understand the Avista Centralia case involved disposition of electric generating assets and the treatment of resulting gains, with consideration given to the unique risks and opportunities created by the sale to various parties.[47] It is entirely appropriate for the Commission to consider the unique facts and circumstances involved in a given case dealing with the gain on sale of a utility asset. I am aware of only one instance where the Commission has previously addressed the sale of directory publishing assets, where it approved a rate case stipulation that flowed the entire Washington gain on sale of Contel Corporation's Leland Mast Directory Company to customers

47 Second Supplemental Order Approving Sale With Conditions, Docket Nos. UE-991255 and UE-991262, 3/6/2000, *86* "Given the risks and burdens borne by the ratepayers and shareholders, and given the other benefits they stand to gain from the sale, we find that it is fair in this case to allocate the appreciation between ratepayers and shareholders. When we apply the principles of *Democratic Central* to the facts of this case, we conclude that one half of the appreciation should go to shareholders, and one half to ratepayers. This is not based on a pre-conceived formula, but on the equities of this distinctive case.

over a five year amortization period to compensate for the official publishing rights being conveyed to the buyer of the business.[48] This Contel gain on sale treatment is entirely consistent with past imputation decisions of the Commission that applied the entire value of the publishing asset, above a reasonable return on tangible investment, to telephone ratepayers.

Q. At pages 8 through 18 of his testimony, Mr. Grate asserts that during the first 40 years of the telephone company's history in Washington, it faced "substantial competition and generated minimal returns. The regulatory scheme in effect during this period clearly left the risk of loss on all of the Company's assets on its investors."[49] Has Mr. Grate provided any evidence that the directory publishing business of Dex that is now worth more than $7 billion developed any significant fraction of its current value during the years prior to 1923?

A. No. In his final analysis on page 25 of his testimony, Mr. Grate calculates his proposed 50/50 sharing by including this initial 40 years within a 60 year period during which he claims shareholders bore the risk of loss on directory operations tangible assets. This means that the 40 years from 1883 to 1923 are extremely important to Mr. Grate's

---

[footnote omitted]"

48 Fourth Supp. Order, 10/26/1987; WUTC Cause No. U-87-640-T, Testimony of Merton Lott 10/12/1987, page 5, Exhibit No. (MRL-2) adjustment RA-4.

analysis, because this distant historical period represents two thirds of the time period supporting Mr. Grate's 50 percent shareholder retention of the Dex gain. However, during this early period it is not obvious whether directory operations achieved any significance in terms of the scope of operations or financial results they achieved. Information presented by the Company in WUTC Docket No. UT-980948 asserted that the business enterprise value of the entire Dex business was approximately $1.5 to $1.8 billion as of January 1, 1984 and that this value was estimated at $4.75 billion in mid-1997.[50] Relative to the proposed sale price of $7.05 billion today, it is obvious that most of the value creation associated with the directory publishing business did not occur during 1883 to 1924.

Q. Has Mr. Grate identified or quantified any specific risks or costs associated with directory publishing in Washington that have been absorbed by shareholders at any time in the Company's history?

A. No. Regarding the first 40-year period from 1883 to 1923, when Mr. Grate was asked to "state with specificity each element of 'financial burden' that is being referenced and

49 Direct Testimony of Philip Grate, page 18.

50 Direct Testimony of Timothy P. Golden, page 4. U S West SEC form 8-K dated 10/27/1997 and Form 8-K/A dated April 13, 1998.

provide the amounts of same for each year in which information is available" in Data Request ATG 7-132, he responded:

> Mr. Grate's testimony explains that 'financial burden' is the burden of providing cost recovery. Until 1923, investors bore the burden of achieving cost recovery in Washington because rates were not subject to cost of service regulation and, not subject to cost of service regulation that was designed to provide recovery of the company's costs. The elements of financial burden to which Mr. Grate's testimony referred include all elements of cost of the telephone service activity and all of the elements of cost of the directory advertising and publishing activities. Preparing a recitation and quantification of each element of these cost [sic] would require a burdensome special study.
>
> No financial information for periods earlier than the year ended June 30, 1913, have been found. See Qwest's Response to ATG Set 7, Data Request No. 110. The financial information in Qwest's possession from the period prior to 1924 is not sufficiently detailed to specifically identify Directory publishing asset investments that were at risk. Under the regulatory scheme in place during the period prior to April of 1923, investors bore the risk on all such asset investments, including investments in recognized assets and unrecognized assets.

The financial data referenced to ATG Set 7, Data Request No. 110 consists of annual Directory Revenue and Directory Expense amounts reported by Pacific Telephone & Telegraph Company that showed expenses in excess of revenues that suggest net losses ranging from $52,816 to $145,844 for the years 1913 to 1917. However, this data and the corresponding information for later years that is shown in Mr. Grate's Exhibit PEG-4 is not specific to the State of Washington and includes PT&T's total company operations at that time in California, Nevada, Oregon, Washington and northern Idaho.

Q. Does the absence of cost of service regulation mean that shareholders bore all risks and financial burdens associated with directory publishing prior to 1924?

A. There has been no showing that directory advertising ever added any risks or financial burdens in Washington. The directory publishing business does not rely upon large tangible asset investments, but is instead dependent mostly upon intangible assets and human resources. The discretionary nature of selling and publishing directory advertising and the minimal incremental capital investment required to enter the directory business makes it highly unlikely that any significant costs or losses would be involved in adding advertising products to printed directories. Absent any business requirement to publish directories at a loss, prudent early telephone company management would have accepted only advertising that could be profitably included within directories.

Q. Mr. Grate's Exhibit PEG-3 at pages 9 and 10 and his Exhibit PEG-4 for the years prior to 1918 suggest that directory publishing operations produced more

expenses than revenues. Does this mean that investors bore any risks or costs associated with development of the directory advertising business?

A. No. The Pacific Telephone & Telegraph values displayed in Exhibit PEG-4 indicate very minimal advertising sales that amounted to 1.5 percent or less of total PT&T revenues in the years 1914 to 1917.[51] The directory expenses shown on Exhibit PEG-4 would include the costs to publish and distribute directories to facilitate telephone service even if no advertising were purchased within the directories and should not be assumed indicative of profitability for a separate directory advertising line of business. Instead, the excess directory expenses relative to advertising revenues should be assumed to relate to a telephone business imperative to provide directories to subscribers and not start up losses associated with the launch

51 Per Qwest's response to ATG 7-110, total annual PT&T revenues ranged from $18.5 to $20.7 million across the fives states served.

of a new directory advertising line of business. Telephone directories were of little value without telephone service and the value of telephone service was enhanced by published directories throughout the distant history addressed by Mr. Grate. This is why the early telephone companies came to be the initial and ultimately the dominant publishers of directories.

Q. What does Exhibit PEG-4 tell us about the nature of directory publishing and advertising, in your opinion?

A. The directory publishing operation has consistently been operated as part of the telephone company throughout history, until the publishing function was moved into an affiliate in 1984. The directories published by Dex today have been developed and augmented over many years while such directories were produced by the regulated telephone company and also while such directories were produced by the affiliate, subject to imputation by the Commission. For all years since 1940, for which Washington specific information is available, directory publishing has been consistently and increasingly profitable.

Q. At page 17 of his testimony, Mr. Grate claims, "In rejecting market value as a basis for establishing rate base in 1916, the Commission established a

principle that it follows to this day. It does not include realized or unrealized goodwill in rate base. By excluding goodwill from rate base, the Commission has always prevented regulated companies from earning a return on goodwill or from recovering losses in the value of goodwill. Thus, Washington ratepayers have never borne the risk of loss on goodwill, including the goodwill of the directory advertising business. Most of the gain on the sale of Dex is attributable to Dex's goodwill; the value of Dex's tangible assets is a relatively minute portion of the total value the Buyers have agreed to pay for Dex". How do you respond to these claims?

A. It was never necessary or appropriate for Pacific Northwest Bell's rate base to be increased because of directory business going concern, market or goodwill value. There are several reasons why "going concern value" for directory publishing was not includable in telephone company rate base:

- No costs were incurred by the Company or its shareholders to establish this goodwill or "going concern" asset, it arose from the telephone company's unique opportunity to publish the directory listings of its subscribers within its official telephone directories and also include in the phone books advertising that was commercially valuable. Thus, directory going concern value was realized at no cost or risk to shareholders.

- The "goodwill" publishing business asset arose from telephone service incumbency, it would have been impossible to convince regulators that telephone customers should pay for a return on or return of such an asset that arises from provision of regulated service.

- Accounting conventions in the United States are premised upon actual costs, rather than theoretical values. Any effort to include a goodwill asset for directory operations in 1916 or at any other date, with no underlying transaction to support such a valuation, would violate these conventions.

- Rate of return regulation in Washington and most other states is based upon actual rate base investment valued at original cost, rather than including the "fair value" of assets in rate base.

However, none of these reasons for excluding intangible goodwill assets in determining rate base supports Mr. Grate's apparent conclusion that anything of value was transferred to ratepayers without any compensation to the investors or that investors bore all the risk of starting and developing that business. Investors have not been required to finance any goodwill investment nor have they ever paid fair value for the intangible assets being referenced by Mr. Grate. Consequently, investors are not entitled to any compensation when such assets are rightfully attributed to telephone customers upon realization as a gain upon sale of Dex.

Q. At pages 14 and 20, Mr. Grate refers to an accounting concept of "mass asset accounting" that he claims to have "found no evidence" was adopted by the Commission in prior rate orders, and from which he concludes, "Whether

ratepayers were at risk for losses on depreciable assets beginning in 1923 is an open question." Does this argument add any weight to Mr. Grate's position that shareholders are entitled to a significant portion of the Dex gain on sale?

A. No. Mass asset accounting relates solely to tangible plant in service accounts and has been the standard method of accounting for telephone plant in service for many years. By Mr. Grate's admission at page 17, "Most of the gain on the sale of Dex is attributable to Dex's goodwill; the value of Dex's tangible assets is a relatively minute portion of the total value the Buyers have agreed to pay for Dex." It is not obvious why Mr. Grate offers negative assurances about evidence that was "not found" to describe unspecified risks and losses related to tangible assets that are only a "minute portion" of the Dex gain that is in dispute.

Intangible goodwill-type assets were addressed previously in my testimony. It should be noted that Mr. Grate's extensive investigation into the distant history of directory publishing has produced no examples where shareholders have suffered any risk, loss or unrecovered cost associated with either tangible or intangible assets associated with the directory publishing business in Washington.

Q. Does Mr. Grate concede that traditional regulation of the telephone company and its directory publishing function starting in 1923 implies that any costs or losses were borne by ratepayers?

A. No. Mr. Grate concedes nothing. Instead, he abruptly shifts to a position that <u>there was no burden</u> from directory publishing at page 19, where he states,

> At no point during this 60-year period did ratepayers bear the financial burden of directory publishing or advertising. In the 1922 test year in this case and in every year since, the revenues from directory sales and advertising substantially exceeded the directory expenses. See Exhibit PGE-4. Revenues from unregulated sales of advertising provided a steady and growing stream of rate support to the Company's regulated telephone operations. Ratepayers enjoyed rate support; they did not bear burden.

Consistent application of this new standard implies that there has never been any "burden" from directory publishing in Washington, because Mr. Grate's Exhibit shows only positive values in the "State of Washington – Net Revenue" column of Exhibit PEG-4.

As to "Risk of Loss" under traditional regulation after 1923, Mr. Grate will concede only that "The evidence is not clear".[52] He proceeds at page 19 to testify about what the Commission "did not say" and implies at page 20 that the Commission would need to "guarantee the Company against loss of property" to meet his "Risk of Loss" standard.

I am not aware of any regulatory commission that has offered a utility such a "guarantee", although costs of property insurance and uninsured casualty losses are routinely incurred and recovered by regulated utilities.

Q. At the bottom of page 22, Mr. Grate references the 1984 transfer of directory assets into the publishing affiliate. He then adds another 20 recent years into the asserted shareholders' share of the Dex gain that he explains by stating, "The investors have borne all of the risk of loss. As of January 1, 1984, the tangible assets were no longer included in the Company's rate base and, therefore, could not present a risk of loss to ratepayers. Because the goodwill of the directory operations was never in ratebase, it never presented ratepayers with a risk of loss." How do you respond to these claims?

A. I will not repeat the many reasons why directory publishing "goodwill" is not includable in rate base. With respect to the publishing affiliate's tangible assets, the Commission's imputation adjustments have allowed a return on these assets at the overall allowed rate of return, imputing only excess earnings above the cost of capital. This methodology is identical in impact to including the assets in telephone rate base. At the time the directory publishing business was moved into and operated within a

52 Direct Testimony of Philip Grate, page 19, lines 13-18.

separate corporate entity, it was never effectively removed from the Commission's jurisdiction because imputation directly recognized all of the investments, expenses, revenues and results of management actions that impacted directory operations. The economic reality of imputation is that it results in the same outcome as actually including directory investments, revenues and expenses within utility accounts.

Q. In his Conclusion on page 25, Mr. Grate states, "ratepayers should receive no more than 50% of the gain realized from the disposition of the tangible assets" and he argues that "they are entitled to none of the gain" with respect to his financial burden test and his gain-related-to-goodwill criteria. Is this position consistent with previous Company representations before this Commission?

A. No. In its most recent advocacy before the WUTC that was intended to cease imputation in Docket No. UT-980948, Company witness Ann Koehler-Christensen sponsored Direct Testimony dated October 16, 1998 that contained the following representations:

> PART III WHAT IS WASHINGTON'S SHARE OF THE TOTAL VALUE OF THE DIRECTORY PUBLISHING BUSINESS.
>
> Q. HOW DID YOU CALCULATE THE VALUE OF THE WASHINGTON PORTION OF THE DIRECTORY PUBLISHING BUSINESS?
> A. I allocated the total value for the directory publishing business arrived at by PwC to the state of Washington using

> Washington's percentage of total directory revenues in 1983. In doing so, I followed the Commission's historical practice of using revenues as the allocator for the purposes of calculating the amount of directory imputation.
>
> Q. HOW DID YOU ARRIVE AT WASHINGTON'S PERCENT OF REVENUES?
> A. I divide the 1983 Account 523, Directory Revenues for the state of Washington by these same revenues for the total of all fourteen states. Washington's percentage in 1983 was 15.63%. At 15.63%, Washington's portion of the total value of the directory operations was between $234,450,000 and $281,340,000.
>
> Q. PLEASE EXPLAIN WHY YOU REDUCE THE VALUE OF THE WASHINGTON PORTION OF THE DIRECTORY PUBLISHING BUSINESS BY THE 1984 ASSET TRANSFER PRICE.
> A. I do so in order to properly calculate the amount necessary to afford Washington ratepayers the benefit of a transfer at fair market value. The valuation, as set forth by PwC, is the gross value of the directory publishing business. It includes both the value that was carried on U S WEST's books and a gain. The difference between the gross value and the transfer price is the additional amount to be passed on to ratepayers.

This testimony in 1998 is dramatically different from the Company's position now regarding the Washington portion of the directory publishing business that should be passed on to ratepayers. According to the Company's new position, the gross value of the directory publishing business enterprise must now be reduced by a series of allocations <u>before</u> the Washington revenue percentage is applied, and then at least a 50 percent attribution of the residual value must be attributed to shareholders. All of the Company's arguments supporting its new 50/50 Dex gain allocation position could have been asserted in the Accounting Order proceeding in 1998, but the Company's position in that case was that ratepayers were entitled to the full gross value of the business, less only the transfer price of assets moved to the affiliate in 1984.

Q. At pages 3, 6 and 7 of his testimony, Qwest witness Mr. Burnett refers to efforts made to expand and improve the directory publishing business that have been made since the 1984 transfer outside the telephone company. Do these enhancements or the additional revenue they produce justify attributing a portion of the value of the gain on sale of Dex to shareholders, rather than QC ratepayers?

A. No. Changes made to printed directories, such as the improvement of fonts, inclusion of color maps, community information pages, colored advertising and white pages enhancements should not be attributed to shareholders at all, because such improvements are simply the result of prudent business management and did not entail any significant startup costs or risks to shareholders. In calculating imputation adjustments in Washington, all of the expenses of Dex management and non-management labor, benefits, materials and contractors were included and reduced imputation amounts. I explained in earlier testimony why Dex earnings associated with secondary directories and non-Qwest listings in primary directories should not be attributed to shareholders.

Q. In calculating imputation adjustments, has the Commission disallowed any Dex expenses associated with the development of new products, such as those listed in Exhibit GAB-3 that is sponsored by Mr. Burnett?

A. Not to my knowledge. There were no disallowed Dex expenses for product development in the imputation adjustments I have reviewed in connection with the last two Washington rate cases.

Q. Mr. Burnett describes the relationship between Dex and QC at page 4 of his direct testimony, stating, "All the tangible and intangible assets, intellectual property, human resources and operational know-how for directory operations were transferred to the new entity." Was any compensation provided to the telephone company or its customers when all of these assets were "transferred to the new entity"?

A. No. The telephone company received compensation for only some cash and certain tangible assets that were transferred at the formation of U S West Direct, as referenced at the top of page 15 of Ms. Jensen's testimony. There was no compensation for the fair market value of the directory publishing business paid to the telephone company or its customers in 1984 as no true sale of the business occurred on that date. The Commission did not approve the compensation associated with the transfers that occurred in 1984 or the publishing agreements commencing at that time, and has treated the directory publishing business as a regulatory utility asset with the Washington portion of Dex revenues, expenses and investment recognized in calculation of imputation adjustments since that date.

Q. At page 4 of his Direct Testimony, Mr. Burnett discusses the existing Publishing Agreement between Dex and QC that designates Dex as the "official publisher" for QC. Then at page 5 he states, "QC does not pay Dex for the services that Dex performs, nor does Dex pay QC under the Publishing Agreement for the right to be QC's official publisher." Has the Commission ever accepted this arrangement for purposes of regulation in Washington?

A. No. Imputation adjustments have been required in Washington in rate cases since 1984 because of the inadequate compensation received by the telephone company under the affiliate Publishing Agreement. The new Publishing Agreement with the Buyer of Dex will perpetuate this arrangement, where no compensation is provided to the telephone company for the "official publisher" designation or for the many other beneficial linkages to the telephone company that are provided. These benefits under the Publishing Agreement and other commercial agreements are secured by the new Non-Competition Agreement in favor of the Buyer represent a large part of what is being purchased for $7.05 billion.

Conclusion

Q. In your opinion, based upon the evidence sponsored by Qwest witnesses in this Docket and the work you have done to evaluate the proposed Dex sale transaction, should the Commission approve the sale of Dex?

A. The proposed Dex sale is vital to the efforts of Qwest to improve liquidity and maintain access to capital on reasonable terms. Therefore, the Dex sale should be approved by the Commission, but QC customers in Washington should be afforded adequate and equitable participation in the financial benefits of the transaction and protection against the risks associated with the transaction. The Washington share of the Dex sale gain should first be dedicated to provision of annual revenue credits in lieu of directory imputation adjustments. The remaining Washington share of the gain calculated on Confidential Exhibit MLB-2C, after accounting for the future annual revenue credits, should be treated as an extraordinary credit to customers on a one-time basis. To ensure against deterioration in service quality as a result of financial pressures upon the business, the existing customer service programs now set to expire or be modified as early as 2003, should be extended through at least the end of 2006. With these conditions, approval of the proposed Rodney transaction can be found to be consistent with the public interest.

Q. Does this conclude your testimony at this time?

A. Yes.