Exhibit T-__(LLS-1T)

Before the

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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

Direct Testimony

of

LEE L. SELWYN

on behalf of the

Washington Utilities and Transportation Commission Staff

March 18, 2003

REDACTED

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INTRODUCTION

Qualifications

Q. Please state your name, position and business address.

A. My name is Lee L. Selwyn. I am President of Economics and Technology, Inc. ("ETI"), Two Center Plaza, Boston, Massachusetts 02108. Economics and Technology, Inc. is a research and consulting firm specializing in telecommunications economics, regulation, management and public policy.

Q. Please summarize your educational background and previous experience in the field of telecommunications regulation and policy.

A. I have prepared a Statement of Qualifications, which is provided in Exhibit No.__(LLS-2).

Q. Dr. Selwyn, have you previously testified before the Washington Utilities and Transportation Commission ("WUTC" or "Commission")?

A. Yes. I have testified before the WUTC on a number of occasions dating back to the late 1970s. In April, 1978, I submitted testimony on behalf of the Boeing Company and Sears, Roebuck and Company in Dockets U-77-50, U-77-51, and U-77-52. In November 1982, I submitted testimony before the Commission on behalf of the Tele-Communications

Association (TCA) in Docket U-82-19 concerning the transfer of Pacific Northwest Bell assets and personnel to AT&T as part of the Plan of Reorganization arising out of the break-up of the former Bell System, and appropriate pricing of terminal equipment. In September, 1988, I submitted two pieces of written testimony to the Commission in Docket U-88-2052-P regarding the competitive classification of certain of Pacific Northwest Bell's services. My testimony on behalf of Public Counsel in that case addressed competitive classification of Pacific Northwest Bell’s intraLATA toll services, while my testimony on behalf of Telecommunications Ratepayers Association for Cost-based and Equitable Rates (TRACER) and the State of Washington Department of Information Services addressed competitive classification of Pacific Northwest Bell’s private line services. In January 1990, I submitted testimony on behalf of TRACER, Public Counsel, and the State of Washington Department of Information Services in Docket U-89-3031-P regarding GTE-Northwest’s proposal for alternative regulation. I also submitted testimony on behalf of TRACER in June 1993, Dockets U-89-2698-F and U-89-3245-P proposing a “Modified Incentive Regulation Plan” for US West Communications (USWC). On April 17, 1995, I submitted direct and supplemental testimony on behalf of the Staff of the Washington Utilities and Transportation Commission in Dockets UT-941464, UT-941465, UT-950-0146 and UT 950265, regarding the cost studies filed by US West in support of its proposed local transport restructure and expanded interconnection tariffs. On August 11, 1995, I submitted testimony in Docket UT-950200 on behalf of the Staff of the Washington Utilities and Transportation Commission concerning US West’s request for an increase in its rates and charges. On October 31, 1997, I offered testimony in Docket UT-961638 on behalf of Public Counsel and TRACER in response to US West’s request to be relieved of its obligation to serve. On March 4 and June 28, 1999 I sponsored responsive and surrebuttal testimony, respectively, in Docket UT-980948 on behalf of WUTC Staff regarding US West's petition and accompanying testimony seeking to end the imputation of "yellow pages" directory advertising revenues to its Washington regulated telephone operations. My most recent appearance before the Commission was in Docket No UT-020406, a complaint proceeding addressing the level of Verizon Northwest's intrastate switched access charges, where I prepared an affidavit and direct testimony on behalf of AT&T, and appeared before the Commission at a hearing held March 7, 2003.

In addition to the aforementioned appearances, ETI has served as a consultant to the Commission and has submitted other filings and reports to the Commission. In October, 1984, ETI prepared a comprehensive evaluation of Local Measured Service (LMS), *A Multi-Part Study of Local Measured Service*, for the WUTC. In 1985, I was co-author, along with Patricia D. Kravtin and Nancy J. Wheatley of ETI, of Reply Comments of the U.S. Department of Energy, Richland Operations Office, regarding cost of service issues bearing on the regulation of telecommunications companies. These Reply Comments were submitted to the Commission in November of that year. In 1987, ETI was engaged by the Commission to undertake an examination of the outside plant construction and utilization practices of US West Communications and to present recommendations based on that investigation. The final report arising from that assignment, *An Analysis of the Outside Plant Provisioning and Utilization Practices of US West Communications in the State of Washington*, was submitted to the Commission in March 1990. I was co-author of that report, along with Patricia D. Kravtin and Paul S. Keller of ETI.

Assignment

Q. On whose behalf is this testimony being offered, and what was your assignment in this proceeding?

A. This testimony is submitted on behalf of the WUTC Commission Staff. I have been asked by the Staff to address certain issues raised by the proposed sale of the Qwest Corporation ("QC") directory publishing affiliate, Qwest Dex, Inc. ("Dex"), in light of the Commission's Order in Docket No. UT-980948. I have been asked to offer an opinion as to whether the proposed sale is in the public interest and, if so, how the substantial gain on that sale should be apportioned as between the parent company Qwest Communications International, Inc. ("QCII") and the Qwest Washington incumbent local exchange carrier ("ILEC") entity, Qwest Corporation, to be used by QC as an offset to its intrastate revenue requirement for the benefit of Washington consumers.

Q. How is your testimony organized?

A. My testimony is organized in three principal sections. The first section addresses the adequacy of the proposed Dex sale price in the context of the total business enterprise value ("BEV") of the Dex operation, as it has been estimated by Qwest's financial advisors in connection with this transaction. The second section discusses the public interest standard that the Commission should apply in considering whether or not the proposed transaction is consistent with the interest of Qwest's ratepayers in Washington. In the third section, I address and respond to Qwest's proposal for a limited flow-through of the gain arising from the sale transaction. Finally, I present Staff's recommendations to the Commission with respect to the proposed sale of Qwest's directory publishing operations..

Overview of the public interest issues arising from the proposed sale of Dex

Q. Dr. Selwyn, can you please provide an overview of the principal issues to be addressed by the Commission in this proceeding with respect to Qwest's proposed sale of its directory publishing affiliate?

A. Yes. Qwest Corporation is asking the Commission to approve the proposed sale of its Washington directory publishing operations, an activity that is currently being managed by QC's affiliate, Qwest Dex, Inc., to a group of outside investors (the "Buyer"). The Commission should approve the proposed transaction *if and only if* it is able to affirmatively determine that the sale of QC's Washington directory publishing operations would be in the public interest. Ordinarily, a public interest determination would require a finding that QC's Washington ratepayers would be made better off from the transaction than they would be in its absence; in the instant case, a more conservative public interest finding would be simply that QC's Washington ratepayers would be made *no worse off* if the sale is permitted to go forward. It is my understanding that the Commission has in the past utilized this latter "ratepayer indifference" standard in considering public utility affiliate and change-of-control transactions.[1] In any event, my testimony demonstrates that, as presently structured by Qwest, neither one of these two criteria is met by the proposed transaction and, accordingly, it should not be approved.

1. *The proposed transaction is taking place under distress conditions, and as such the proposed sale price is less than the fair market value of the directory publishing operation.*

The testimony being offered by Qwest in this proceeding makes it clear that the sale of its directory affiliate Dex is being undertaken with great reluctance, as a "last resort" by Qwest to stave off bankruptcy of the parent corporation, QCII. Qwest indicates that it had explored other alternatives for resolving its current financial crisis, but in the end had concluded the sale of Dex is the only real choice available to it. These facts and the generally dismal state of QCII's financial condition are well known to the investment community generally and certainly to the Buyer, a highly savvy and sophisticated group of Wall Street professionals. The transaction is clearly a "distress sale" that is to take place at what can only be characterized as a "distress price." Qwest's own financial advisors have each estimated BEGIN QWEST CONFIDENTIAL <<[redacted]>> END QWEST CONFIDENTIAL than the $7.05-billion in cash that Qwest is to receive from the sale. While the transaction will (perhaps) provide Qwest with the cash it needs immediately to avoid bankruptcy, the less-than-fair-value price will in the end compromise Qwest's financial strength over the long term. As Dr. Blackmon explains, there is no assurance that

1. WUTC Docket No. UE-981627, *In the Matter of Application of PacifiCorp and Scottish Power*, Fifth Supplemental Order (October 14, 1999), at 8.

this short-run infusion of cash will, in the final analysis, prevent QCII from ultimately being forced into bankruptcy.

2. *Qwest has failed to demonstrate that the financial woes, and possible bankruptcy of QCII, will have a material adverse impact upon QC's ability to furnish safe and reliable local exchange telephone service to consumers and businesses in Washington state.*

The severe financial difficulties that prevail at QCII are attributable *in their entirety* to the parent company's nonregulated, non-ILEC activities, such as its interexchange and international businesses, and various questionable financial transactions and maneuvers occurring at the parent company level, and distinctly *not* from its ILEC operations in the former US West operating companies. While the parent QCII is an equity holder of QC stock and (perhaps) a creditor as well, for the most part the ILEC's finances exist largely independently of those of the parent. Indeed, QCII is forbidden by federal law and FCC regulations from pledging any of QC's regulatory assets as a basis for its nonregulated, non-ILEC ventures.[2] As Dr. Blackmon explains, a QCII bankruptcy would likely place QCII's holdings of QC stock in jeopardy (i.e., as an asset of the bankrupt QCII), but that alone would not in and of itself threaten the financial integrity of QC or its ability to provide regulated local exchange telephone services in Washington. Since ratepayers receive no

2. *See generally*, *In the Matter of Implementation of the Telecommunications Act of 1996: Accounting Safeguards*, 11 FCC Rcd 17539 (1996), at paras. 3-12, which summarizes the multiple provisions under the Telecommunications Act of 1996 intended to prohibit cross-subsidization of noncompetitive telecommunications services by services subject to competition, including the general prohibition contained in Section 254(k) of the Act. At para. 24 of this order, the FCC states explicitly that "protecting ratepayers from cross-subsidizing competitive ventures is a primary goal behind all our cost allocation and affiliate transactions rules."

particular "benefit" from QCII's avoidance of bankruptcy (assuming, *arguendo*, that the Dex sale will result in the permanent avoidance of QCII bankruptcy in the first place), that outcome of the sale transaction produces no ratepayer benefits and cannot provide a basis for the Commission's public interest determination.

3. *The proposed transaction will weaken QC's financial position in Washington, and lead ultimately to higher rates for monopoly local exchange telephone services than those that would otherwise prevail in the absence of the sale transaction.*

In exchange for granting Dex the right to publish white and yellow pages directories in Washington state, QC is required by the Commission annually to impute the equivalent of the profits earned by Dex on the Washington directory business into the QC revenue requirement. Indeed, this requirement was recently reaffirmed by the Commission in Docket No. UT-980948,[3] a proceeding in which QC had actually sought to discontinue the imputation requirement. Imputation levels are currently running in the range of $85-million (pre-tax) annually. All else being equal, that amount can be expected to increase over time so as to track and capture growth in Dex earnings. Based upon earnings growth projections developed by Qwest's financial advisors in connection with the Dex sale transaction, the net present value of these imputation amounts, which are to continue indefinitely under the existing regulatory scheme, amounts to some BEGIN QWEST HIGHLY CONFIDENTIAL << [redacted] >> END QWEST HIGHLY CONFIDENTIAL Under the terms of the proposed sale, however, those imputations would continue for four years at $103.4-million,

3. *In Re the Petition of U S West Communications Inc., for an Accounting Order*, Docket No. UT-980948, *Fourteenth Supplemental Order; Order Denying Petition*, July 10, 2000 (hereinafter, "*Yellow Pages Imputation Accounting Order*"),

then would be decreased to BEGIN QWEST HIGHLY CONFIDENTIAL <<[redacted] >> END QWEST HIGHLY CONFIDENTIAL in year 5, and would cease altogether thereafter; the net present value of these imputations is only BEGIN QWEST HIGHLY CONFIDENTIAL << [redacted] >> END QWEST HIGHLY CONFIDENTIAL representing a net loss (in present value terms) to QC, and to QC ratepayers in Washington, of approximately BEGIN QWEST HIGHLY CONFIDENTIAL <<[redacted] >> END QWEST HIGHLY CONFIDENTIAL If the sale of Dex goes through and these imputations are discontinued as contemplated in the sale transaction, QC will be forced to make up the shortfall through increases in prices for its regulated (monopoly) local exchange telephone services or, failing that, will suffer a sustained revenue deficiency that has the potential to permanently impair the Company's ability to provide safe and reliable local exchange telephone service in Washington. Even if a QCII bankruptcy posed some risks to Washington consumers, and, as Dr. Blackmon explains, that outcome is highly doubtful, there is certainly no basis to believe that the consequences of a QCII bankruptcy would ever come even remotely close to exceeding the known, measurable, and uncontroverted BEGIN QWEST HIGHLY CONFIDENTIAL <<[redacted] >> END QWEST HIGHLY CONFIDENTIAL loss of imputation to which QC is presently entitled.

4. *Not only does Qwest plan to discontinue the Commission-ordered imputations after five years, it claims to have no obligation to flow through any of the substantial gains from the sale of Dex to Washington ratepayers, as expressly required by this Commission in similar utility asset sale situations and, more generally, by the landmark Democratic Central Committee federal court ruling.*

Although the WUTC has ruled, in a heavily contested proceeding, that Qwest's Washington directory publishing operations is a regulatory asset of QC and was never "transferred" to Dex, Qwest nonetheless persists in reiterating and rearguing the theory that the Washington directory operations are the property of Dex and that, as such, QC and its ratepayers have no entitlement to any of the gains on the sale of those assets. In fact, the Washington directory publishing operations are not Dex's to sell, because this Commission has determined that they were never transferred to Dex in the first place. Moreover, as shall I explain in detail in the testimony that follows, and contrary to Qwest's contention, virtually all of the value of the directory publishing operations arises from the QC legacy local service monopoly franchise, and not from any investment or innovation on the part of Dex. But for the preexisting Directory Publishing Agreement with (then) US West, Dex would not be providing the Washington directories, and would have no Washington assets to offer for sale. Additionally, as structured, the sale transaction itself recognizes the ongoing critical importance of continued QC involvement in the directory publishing activity, in that under the terms of the sale QC is required *post-sale* to provide a variety of ongoing services and accommodations to Dex, and to enter into a non-compete agreement with the Buyer, for a period of as long as fifty years. Hence, even if the Commission had not previously determined that Qwest's directory publishing operation in Washington is a regulatory asset of QC, virtually all of the value that is being conveyed to the Buyer resides not in Dex, but in the 14-state operations of the Qwest ILEC, QC.

5. *The Commission should find that the proposed sale of the Qwest Dex directory publishing business in Washington State is not in the public interest, and on that basis not approve the proposed transaction as structured.*

The sale of Qwest's Washington directory publishing operations, as structured in the proposed transaction, will make ratepayers decidedly worse off and hence fails to satisfy the "ratepayer indifference" standard. As such, the Commission should conclude that the sale would not be in the public interest, and on the basis should not allow the transaction to go forward. However, if the Commission determines that the transaction should be approved with certain modifications, it should require that, from a regulatory perspective, the transaction be structured so as to assure that Washington ratepayers are not harmed. At the very least, the Commission should (a) impute a fair market value for the purchase price, rather than the under duress purchase price agreed to by Qwest, in valuing the sale transaction, and (b) require that 100% of the gain on the sale (at the imputed fair value price) be flowed through to Washington ratepayers. If the combined effect of these adjustments makes Washington ratepayers no worse off than under the present imputation arrangement, the ratepayer indifference standard for a public interest finding can be satisfied, and the transaction can be permitted to go forward.

VALUATION OF THE DEX SALE TRANSACTION

The sale of the Dex directory business has been compelled by the financial crisis currently confronting Qwest's parent, QCII, and is not required to maintain the financial integrity or viability of Qwest's regulated operations in Washington.

Q. What is the nature of the Qwest affiliate that is the focus of this proceeding, Qwest Dex, Inc.?

A. Qwest Dex, Inc. ("Dex") is the entity in the Qwest family of companies that undertakes the compilation and publication of white and yellow pages directories in the fourteen-state Qwest region. Like the regulated incumbent local exchange carrier (ILEC) entity, Qwest Corporation ("QC"), Dex is a subsidiary of Qwest Services Corporation ("QSC"),[4] and both Dex and QC ultimately are owned by the parent holding company, Qwest Communications International, Inc. ("QCII").[5] At the time of the break-up of the former Bell System in 1984, Qwest's predecessor US West, Inc. created a new entity, US West Direct, to undertake directory publishing activities on behalf of all of the US West operating companies supplying regulated telephone services in the fourteen-state US West region.[6] US West

4. To be precise, Dex is owned by an intermediary entity, Dex Holdings, Inc., which is wholly-owned by QSC. Jensen (Qwest) Exhibit TAJ-1T, at 7.

5. *Id.* at 7 and Cummings Exhibit PCC-2 ("Qwest Corporate Structure").

6. Burnett (Qwest) Exhibit GAB-1T, at 3-4.

Direct was subsequently renamed US West Dex, and then became Qwest Dex, Inc. at the time that Qwest and US West merged.[7]

Q. What is your understanding of the process by which the Dex operation is being sold by QCII?

A. On August 19, 2002, QCII reached an agreement to sell Dex to a consortium including two private equity firms, The Carlyle Group ("Carlyle") and Welsh, Carson, Andersen & Stowe ("WCAS"), collectively the "Buyer."[8] The total sale price for Dex is approximately $7.05-billion, subject to some variation due to certain aspects of the sale transaction that will not be fixed until the date of closing, such as the Dex net book value.[9] The sale transaction has been structured into two phases, with the first phase (referred to as "Dexter") involving the sale of Dex's operations in seven states for $2.75-billion,[10] and the second phase (known as "Rodney") involves the Dex operations in the remaining seven states, including Washington, for the balance of the purchase price, approximately $4.3-billion.[11]

7. *Id.* at 3-4.

8. Burnett (Qwest) Exhibit GAB-1T, at 1.

9. Jensen (Qwest) Exhibit TAJ-1T, at 25.

10. The seven Dexter states are Colorado, Iowa, Minnesota, Nebraska, New Mexico, North Dakota, and South Dakota. The Dexter phase closed effective November 8, 2002. Jensen (Qwest) Exhibit TAJ-1T, at 3.

11. The Rodney states are Arizona, Idaho, Montana, Oregon, Utah, Washington, and Wyoming. Jensen (Qwest) Exhibit TAJ-1T, at 3.

Q. Has Qwest provided the Commission with any explanation as to why QCII has decided to sell the Dex business?

A. Yes. Qwest has offered the testimony of two witnesses to explain why QCII has decided to sell the Dex business, Qwest Corporation's Director of Finance, Peter C. Cummings, and a former US West employee (now an independent consultant), Brian G. Johnson. As these witnesses explain, QCII's financial condition is precarious, and bankruptcy is a real possibility unless to parent company can raise sufficient cash sufficiently soon to satisfy its debt service obligations and remain operational. They explain that QCII has examined various strategies for accomplishing this, and that QCII has concluded that the sale of Dex is the only viable option available to it at this time. The witnesses concede that:

(1) *QCII decided to sell Dex in 2002 in order to raise sufficient cash in time to meet heavy debt payments, at a time when QCII faced falling revenues and earnings, and a debt load of over $25-billion.* As expressed by Mr. Cummings:

> It is necessary to review the events in the months leading up to the Dex sale transaction in August 2002 in order to understand the financial situation that led QCII to consider selling Dex. In January 2002, QCII had declining EBITDA, declining revenues, and over $25 billion in debt on its balance sheets.
>
> ...
>
> QCII's stock price had steadily declined from the mid-$40s in January 2001 to the mid-teens by January 2002. ... There was concern in the financial markets and a high level of scrutiny from investment analysts regarding QCII's financial condition. By the beginning of 2002, it was apparent that the economic downturn coupled with reduced demand and overcapacity in the telecommunications industry

> placed QCII at serious risk of being unable to generate sufficient cash flow to service its debt obligations.[12]

(2) *QCII's liquidity problems were exacerbated by the SEC probe into accounting irregularities relating to QCII's prior statements of its financial results.*

> The announcement of the informal investigation [by the SEC] likely created doubts in the minds of investors about how to evaluate QCII, because the inquiry raised questions as to QCII's prior financial results and future earnings. On April 3, 2002, the SEC issued a formal order of investigation. Because of the SEC investigation, QCII could not issue new stock or bonds to the public in a registered offering. ...[13]

(3) *By April 2002, QCII had no viable option other than the sale of Dex to avoid default on its debt and a resulting bankruptcy.* As explained in Mr. Johnson's testimony:

> Further, QCII had ever dwindling options to raise cash necessary to make upcoming required payments under the Amended Credit Facility in 2003.
>
> ....
>
> QCII and QC were locked out of the commercial paper market. Their ability to issue intermediate and long term debt was increasingly hampered by the decline, ultimately into junk status, of their credit ratings.
>
> ...
>
> QCII's dwindling stock price made a public stock issue impractical; the SEC investigation made a public stock sale impossible.
>
> ...

12. Cummings (Qwest) Exhibit PCC-1T, at 8-9, footnotes omitted.

13. *Id.*, at 12.

> Increased revenues from internal operations was not an option. ... Further reducing operational expenses was also not a viable option to significantly increase cash flow.[14]

Mr. Johnson also states that the sale of other assets, including access lines or QCII's wireless business, was considered, but those options were unacceptable because they would either take too long to accomplish or fail to produce sufficient cash to meet QCII's immediate needs.[15] It was in these circumstances, when there were no other viable options, that QCII moved ahead and negotiated the sale of Dex.[16]

Q. What are the implications of these circumstances for the sale price that QCII was able to obtain for Dex?

A. The QCII financial melt-down as described by Messrs. Cummings and Johnson was heavily publicized and was certainly well-known to the financial community. QCII began accepting offers for the Dex business at a time (April 2002) when it needed to sell Dex quickly in order to raise sufficient cash to avert QCII's bankruptcy. Potential bidders would have been fully aware of QCII's rapidly-worsening financial crisis, and would have factored the distress nature of the Dex sale into their offers. These circumstances combined to create a "buyer's market" condition with respect to this offering, and as such placed QCII at a distinct disadvantage relative to potential bidders when trying to negotiate the highest

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14. Cummings (Qwest) Exhibit BGJ -1T, at 4-5.

15. *Id.,* at 5-6.

16. *Id.,* at 6.

possible sale price for Dex. As I explain later in my testimony, the sale price that QCII was ultimately able to negotiate with the Buyer is approximately BEGIN QWEST CONFIDENTIAL << [redacted] END QWEST CONFIDENTIAL>> than the mid-point of the range of BEV valuation estimates developed by QCII's financial advisors supporting the Dex transaction. The fact that the sale price was significantly lower than the estimated market value of Dex compels the conclusion that QCII was unable to negotiate a sale at Dex's full market value because of the "distress" nature of the sale.

Moreover, it is also clear from the testimony of Messrs. Cummings and Johnson that the financial distress that compelled the Dex sale stemmed from business conditions extant at the parent holding company, QCII, and not from economic or market conditions confronting the regulated operating company, Qwest Corporation, specifically. Contemporary reports by financial analysts at that time also reinforce this conclusion.

Q. To what reports are you referring?

A. Financial analysts' reports on Qwest in the late 2001 through mid-2002 time frame recognized the distinctly different financial conditions of the parent QCII as distinct from that of the operating telephone company subsidiary, QC, and noted that the regulated telephone operations were a core strength of Qwest's overall business. For example, the *Value Line Investment Survey* dated December 7, 2001 stated that:

> Qwest Communications is facing a couple of quarters of flat revenue. A shift in the purchasing behavior of many of its wholesale customers (from 3-7 year

> contracts, to month-to-month agreements) is having a negative impact on top-line growth. Specifically, sales of irus (long-term leasing of a portion of an international cable network) decreased $400 million in the third quarter on a sequential basis. We project another $400 million decline in the December period. Too, persistent weakness in the economy should prevent Qwest's other areas of business — Commercial and Consumer Services — from making up the slack.
>
> **That said, the long-term prospects for the company appear promising.** *Its 14-state local network (over 18 million access lines) provides the company with a competitive edge over those carriers with no local presence. Besides supplying a steady cash flow,* the local network has great value as a means to control customer traffic end-to-end.[17]

Similarly, Standard and Poor's *Credit Week* report issued January 2, 2002 gave a "revised" outlook for QCII. As reported therein on December 14, 2002, S&P "revised its outlook to negative from stable on Qwest Communications International Inc. At the same time, S&P affirmed its ratings for QC,[18] noting that:

> [the rating on Qwest reflects the strength of its local exchange business, offset by its less mature and price-sensitive data and IP products. The local exchange business, which is the former U S West, contributes nearly 90% of EBITDA and faces limited competition. Conversely, the company's data and IP business segment is highly cyclical and faces intense competition due to the glut of fiber capacity and the reduced spending by telecom carriers for such services.[19]

A subsequent *S&P Credit Week* report expressed the following opinion when giving Qwest Corporation a "New Rating":

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17. Value Line Investment Survey, December 7, 2001, at 731 (emphasis supplied).

18. Standard & Poor's Credit Week, January 2, 2002, at 196.

19. *Id.*, at 196-197.

> 'Although debt at Qwest Communications International and funding conduit Qwest Capital Funding is structurally subordinated to debt at Qwest Corp., we do not currently notch down the debt at either the parent or Qwest Capital Funding because of the value ascribed primarily to the company's 18 million local exchange access lines and the directory business," Standard & Poor's credit analyst Greg Zapping said.[20]

Finally, the *Value Line Investment Survey* dated March 8, 2002 provided an update concerning the SEC's accounting investigation of QCII and QCII's liquidity problems and responses, and concluded as follows:

> We advise investors to avoid these shares for now. True, the stock has fallen steeply, so much so that perhaps its U.S. West operation in and of itself is worth more than the current quote. However, there are still too many outstanding matters relating to the company's accounting practices, debt levels, and potential asset sales that need to be resolved.[21]

Copies of each of these financial reports are provided in Exhibit No.__(LLS-3).

As these reports make clear, in the late 2001 through early 2002 time frame, third party financial analysts were of the opinion that Qwest's overall financial predicament was mainly due to the poor performance of QCII's unregulated lines of business, such as its sale of fiber optic capacity, and that the regulated operations of Qwest Corporation have generally

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20. S&P Credit Week, March 7, 2002, at 137. I would observe, incidentally, that the fact that "debt at Qwest Communications International and funding conduit Qwest Capital Funding is structurally subordinated to debt at Qwest Corp." provides additional support for Dr. Blackmon's conclusion that QCII bankruptcy would have minimal impact upon QC's continuing operations in Washington, and that QC would indeed be financially healthy if separated altogether from QCII.

21. Value Line Investment Survey, March 8, 2002, at 736 (emphasis deleted).

remained financially sound. An April 2002 *Wall Street Journal* article notes that Qwest is flowing profits from its regulated monopoly operations to prop up its various nonregulated and financially-stressed business activities. The article quotes Bruce McDowell, a Qwest employee and union official, as stating that "Qwest has been milking the cash cow to keep them in the game... If Qwest didn't have USWest, they'd be in bankruptcy." The same article also notes that "[then-Qwest Chief Executive Joseph P. Nacchio] dismisses talk of bankruptcy and says he's 'not ashamed' that USWest is propping up Qwest, saying it's part of his 'long-term strategy.'"[22]

Q. Have you been able to corroborate the conclusion that QC is propping up the rest of QCII by an examination of Qwest's financial statements?

A. Yes, in part. I have reviewed the financial statements of QCII and Qwest Corporation for the years 2000 and 2001. Exhibit No.__(LLS-4C) (ETI Analysis of QCII and QC Financial Statements) provides an analysis of the earnings/losses sustained by each of these Qwest entities in those years. My analysis is based upon the Qwest Corp. Form 10-K filed with the SEC on March 31, 2002, and QCII's Form 10-K filed with the SEC on April 1, 2002. In view of the ongoing SEC investigation into Qwest's financial reporting and Qwest's admission that it had misrepresented its revenues, costs, and earnings in significant respects in financial statements, I cannot offer definitive figures for the financial performance of QCII or QC at this time. However, it appears that the analysis I present below would

22. Deborah Soloman, "Bad Connection: How Qwest's Merger with a Baby Bell Left Both in Trouble," *Wall Street Journal*, April 2, 2002, at A1.

provide an upper bound to the profitability of QCII, given that Qwest's financial restatements to date have lowered earnings estimates, and more restatements are likely to do the same. On the basis of the financial statements I used, QC, the regulated ILEC for the 14-state region, earned significant profits in both 2000 and 2001 — specifically, QC had Net Income of $1.56-billion in 2000 and $1.20-billion in 2001.[23] On a rate of return basis, those net income levels represent returns of 8.6% and 6.2%, respectively.[24] In contrast, QCII had enormous operating losses during each of those years. On the income statements used in my analyses, QCII reported NOIs of *negative* $81-million in 2000 and *negative* $4.02-billion in 2001.[25] Since QC is a wholly-owned subsidiary of QCII, its contributions to QCII's income statement can be subtracted out of the consolidated QCII income, revealing even greater losses from QCII's nonregulated (i.e., non-QC) operations, with NOIs of *negative* $1.64-billion in 2000 and *negative* $5.22-billion in 2001.[26] Significantly, Dex earnings, which are of course *positive*, are included within these non-QC amounts. When the Dex earnings are also excluded, the non-QC, non-Dex components of QCII are seen to have generated a loss of BEGIN QWEST CONFIDENTIAL <<[redacted] >> END QWEST CONFIDENTIAL in 2001.[27] Thus, the available financial information from the Qwest companies corroborates the conclusion that QC has continued to maintain significant positive cash flow and remains

23. Exhibit No.__(LLS-4C), Table 2.

24. In year 2001, QC had merger-related charges of $1.285-billion. Excluding those charges, its net income for 2001 was $2.48-billion and return on rate base 12.8%.

25. Exhibit No.__(LLS-4C), Table 1.

26. Exhibit No.__(LLS-4C), Table 3.

27. Exhibit No.__(LLS-4C), Tables 4 and 5.

fundamentally healthy as a financial matter, whereas QCII's nonregulated and non-Dex operations have sustained huge financial losses and are undeniably entirely responsible for QCII's current financial crisis.

Q. Have you been able to provide a similar analysis for 2002?

A. No, because Qwest Corp. and QCII have thus far delayed their filing of 10-K (annual) and 10-Q (quarterly) financial statements for 2002 because of the ongoing SEC probe and internal investigations of the accuracy of their prior accounting and financial reporting. As explained in QCII's Notification of Late Filing 10-Q, filed with the FCC on November 2, 2002:

> As announced in its press releases, each filed as an Exhibit to Forms 8-K filed on July 29, 2002, August 8, 2002, September 23, 2002 and October 29, 2002, earlier this year Qwest Communications International Inc. ("the Company") and its board of directors began an analysis of, among other things, revenue recognition and accounting treatment for optical capacity asset sales (particularly sales to customers from which the Company agreed to purchase optical capacity assets), the sale of equipment by the Company to certain customers and certain accounting policies and practices with respect to its Qwest Dex, Inc. ("Qwest Dex") directories business, including, among other things, the changes in the production schedules and lives of some of its Qwest Dex directories. The Company expects that it will restate prior periods as a result of its determination that certain accounting policies may have been inappropriately applied and certain transactions were recorded incorrectly.
>
> These releases also gave updates on the status of investigations by regulatory agencies, the Company's internal review and the audits and reviews by the Company's external auditors, KPMG LLP ("KPMG"). As all restatement matters are subject to audit by KPMG, the Company can give no assurance that all adjustments necessary to present its financial statements in accordance with generally accepted accounting principles have been identified as of the

> time of this filing. Accordingly, the Company cannot state with certainty when a restatement will be completed, and consequently, the Company is not in a position to timely file its Quarterly Report on Form 10-Q.
>
> The Company will file its Quarterly Report on Form 10-Q for the third quarter ended September 30, 2002 when (1) its restatement is complete, (2) KPMG has completed a re-audit of the relevant periods, and (3) the Company's chief executive officer and chief financial officer are able to make the certifications required by Section 302 of the Sarbanes-Oxley Act. The Company cannot state with certainty when these events will be completed.

Q. Earlier in your testimony you referred to Qwest's admission that QCII's liquidity problems were exacerbated by the 2002 SEC investigation into QCII's accounting and financial reporting. How is this investigation relevant to the valuation of the Dex business?

A. There are at least three respects in which the SEC investigation bears upon the valuation of the Dex business. First, to the extent that QCII management may have taken actions that resulted in misrepresentation of QCII's financial results (either intentionally or inadvertently), then QCII's management bears full responsibility for the consequences of those actions, including any shortfall in the Dex sale proceeds compared to Dex's business enterprise value that occurred as a result of the distress nature of the sale. Accordingly, the Commission would be justified in insulating Washington ratepayers from such a shortfall, and imputing for Qwest ratemaking purposes the full business enterprise value of the Washington portion of Dex's operations, rather than the Washington share of the lower sale price that was actually achieved. Second, the fact that the SEC investigation was publicly announced and initiated just as QCII started to solicit bids for Dex means that bidders had to be aware that QCII was financially vulnerable and essentially desperate to sell the Dex business for cash as soon as possible. And finally, to the extent that potential bidders may have questioned the legitimacy of Qwest's financial reporting, that could have pushed bid prices downward.

Q. Was the sale of Dex necessary in order to prevent Qwest Corporation from serious financial harm as a result of QCII's liquidity problems and inability to service its debt in early 2002?

A. That is Qwest's contention, but the Company has failed to offer any compelling support for this claim. As the financial analysts that I cited earlier have suggested, *if anything* financial support is flowing *from* QC *to* QCII, not the other way around. QC is fully capable of surviving as a financially strong ILEC if stripped of its linkages with QCII, especially if QC is also able to retain the directory publishing operation. In that regard, Washington consumers would likely be far better off, for example, if the Commission were to require that QC be spun off from QCII than if the sale of Dex is allowed to go forward.

Review of the valuation studies conducted by Qwest's financial advisors confirms that the $7.05-billion negotiated sale price for Dex is BEGIN QWEST CONFIDENTIAL <<[redacted]>> END QWEST CONFIDENTIAL of Dex's fair market value.

Q. Dr. Selwyn, have you had an opportunity to review the various valuation estimates for the Dex business that were conducted by QCII's financial advisors for the sale transaction?

A. Yes. In order to proceed with its planned sale of Dex, QCII hired two well-known investment banking firms, Lehman Brothers and Merrill Lynch, as financial advisors.[28] Both firms provided QCII with a series of valuations of the Dex business in 2002, utilizing techniques commonly applied for such evaluations, including discounted cash flow ("DCF") analyses, analyses of comparable sale transactions, and consideration of the market value of comparable businesses. These studies did not specifically address the valuation of the Washington portion of the Dex business, but instead addressed either the Dex business as a whole or, in some cases, the value of what has become known as the "Dexter" portion (the first stage) of the sale transaction. In addition, both firms provided fairness opinions to QCII addressing the adequacy of the negotiated sale price for Dex overall in the context of the financial circumstances faced by QCI.

Q. What were the results of the Lehman Brothers valuations for the Dex business enterprise value?

A. In response to data requests propounded by the Washington Attorney General ("ATG"), Qwest has turned over several documents prepared by Lehman Brothers that presented its Dex valuation analyses to QCII. In chronological order, these documents consisted of:

28. Qwest Response to ATG 01-004.

BEGIN QWEST CONFIDENTIAL<<

[redacted]

[redacted] >> END QWEST CONFIDENTIAL

BEGIN QWEST CONFIDENTIAL << [redacted]

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29. Qwest Response to ATG 01-009S1, Confidential Attachment C.

30. Qwest Response to ATG 01-005, Confidential Attachment A.

31. Qwest Response to ATG 01-005, Confidential Attachment E.

32. Qwest Response to ATG 01-005, Confidential Attachment C. BEGIN QWEST CONFIDENTIAL<< [redacted].>> END QWEST CONFIDENTIAL

[redacted]

>> END QWEST CONFIDENTIAL.

Q. Did Lehman Brothers draw any conclusions from its valuations of Dex?

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33. BEGIN QWEST CONFIDENTIAL<< [redacted] >>END QWEST CONFIDENTIAL

34. For further details on the methodologies and assumptions underlying those valuations, see the Lehman Brothers August 19, 2002 presentation (reproduced as Exhibit No.__(LLS-6C) to my testimony).

Table 1

[redacted]

A. BEGIN QWEST CONFIDENTIAL<< [redacted]

[redacted]

[redacted]

[redacted]

[redacted]

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35. Emphasis in the original. *Id.*, at 9.

[redacted] >> END QWEST CONFIDENTIAL

Q. How do the other Dex valuations undertaken by Lehman Brothers compare to those in the August 19 Presentation?

A. The other Dex valuations that had been previously conducted by Lehman Brothers BEGIN QWEST CONFIDENTIAL <<[redacted]

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36. Qwest Response to ATG 01-005, Confidential Attachment A.

37. BEGIN QWEST CONFIDENTIAL<<[redacted]>>END QWEST CONFIDENTIAL

[redacted]

[redacted]

[redacted]

[redacted]>> END QWEST CONFIDENTIAL

Overall, on the basis of those DCF analyses and its other valuation techniques, Lehman Brothers concluded that Dex's enterprise value at that time was between BEGIN QWEST CONFIDENTIAL <<[redacted]>> END QWEST CONFIDENTIAL.[40] The mid-point of that valuation range, BEGIN QWEST CONFIDENTIAL <<[redacted]>> END QWEST CONFIDENTIAL, is some BEGIN QWEST CONFIDENTIAL <<[redacted]>> END QWEST CONFIDENTIAL more than the $7.05-billion sale price that QCII ultimately accepted.

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38. Qwest Response to ATG 01-009S1, Confidential Attachment C.

39. BEGIN QWEST CONFIDENTIAL<<[redacted]>>END QWEST CONFIDENTIAL

40. Lehman Brothers February 3Presentation at 6 (provided as Confidential Attachment C to ATG 01-009S1).

Q. You mentioned earlier that QCII's other financial advisor, Merrill Lynch, had also conducted valuation studies of the Dex business. Did Merrill Lynch end up with valuation results similar to those of Lehman Brothers?

A. BEGIN QWEST CONFIDENTIAL<<[redacted]>>END QWEST CONFIDENTIAL I have reproduced this chart as Confidential Exhibit No. __ (LLS-9C). This chart clearly shows that the BEGIN QWEST CONFIDENTIAL<<[redacted]>> END QWEST CONFIDENTIAL, some BEGIN QWEST CONFIDENTIAL <<[redacted]>>END QWEST CONFIDENTIAL the nominal sale price of $7.05-billion. See Confidential Exhibit No. __ (LLS-8C) to my testimony for more details concerning these valuations.

Q. Did Merrill Lynch make explicit findings concerning the sale price's relationship to its valuation range in the August 19 Presentation?

41. Qwest Response to ATG 01-005, Confidential Attachment D ("Presentation to the Board of Directors of Qwest Regarding Dex Divestiture," August 19, 2002). This document is reproduced in my Confidential Exhibit No. __(LLS-8C) and henceforth is referred to as the Merrill Lynch August 19 Presentation. BEGIN QWEST CONFIDENTIAL<<[redacted]>>END QWEST CONFIDENTIAL

A. BEGIN QWEST CONFIDENTIAL<<[redacted]>>END QWEST CONFIDENTIAL

Q. Are there additional valuation studies of the Dex business that reinforce the conclusion that BEGIN QWEST CONFIDENTIAL<<[redacted]>>END QWEST CONFIDENTIAL

A. Yes, there are. Qwest has supplied documents that present valuation estimates for the Dex business that were performed by other third-party financial analysts just prior to the decision to sell Dex (i.e., first quarter 2002). Qwest has described these valuations as follows:

> In late January 2002, Qwest requested that interested investment bankers examine the viability of a potential tracking stock for the publishing business (referred to as the "Dex tracker"). During the course of examination of a potential tracking stock, several external investment bankers conducted analyses of Dex financials. The valuation estimates of Dex were thus provided

42. *Id.* at 11.

> in the context of a possible tracking stock and not in a context of a sale of the publishing business. The written material (including the valuation analyses) provided by the investment bankers in response to Qwest's request was based on a preliminary set of summary data. The valuations developed by the investment bankers were provided to Qwest as part of a solicitation by the bankers to be engaged to assist Qwest on the potential tracking stock project. By the end of March 2002, Qwest determined that the tracking stock approach was not viable. At that time, Qwest commenced the process that led to the agreement to sell the publishing business.[43]

Q. Does the fact that these valuations were performed in the context of a potential tracking stock reduce their relevance to a determination of Dex's enterprise value?

A. No, not at all. While the valuation studies that I had described earlier in my testimony were conducted a few months later, these studies were also aimed at determining the business enterprise value of the Dex business, just like the studies performed by Qwest's financial advisors. The only difference that one would anticipate in the results of these studies versus those undertaken by Qwest's financial advisors would be in the estimated costs of the transaction being contemplated, i.e., the costs of completing an outright sale vs. those of implementing a tracking stock mechanism.

Q. What were the results of the investment bankers' valuations of Dex?

43. Qwest Reponse to ATG 01-009, 10/28/02 Supplemental Response.

A. Additional valuation analyses were performed by the investment banking firms of Bear Stearns, Credit Suisse First Boston, and J.P. Morgan, using a variety of valuation techniques.[44] Their valuation estimates for Dex are summarized in Table 2 below:

Table 2

[redacted]

Q. Is there another valuation estimate for the Dex business that you believe the Commission should consider?

A. Yes. During Qwest's work with its financial advisors for the Dex sale, Dex's management provided the advisors with financial projections for the business for the years 2002-2006. A

44. Lehman Brothers and Merrill Lynch also provided valuations under the tracking stock scenario, which were superseded by their subsequent valuations discussed earlier in my testimony.

valuation based upon those projections should be of particular interest to the Commission, because it represents the value that Dex's management believed the Dex business to have just prior to the date when the sale transaction was agreed to. Consequently, I have prepared a discounted cash flow analysis of Dex based upon those financial projections, generally following the DCF analysis provided by Bear Stearns in its February 2, 2002 presentation.[45] This analysis, which is presented in Confidential Exhibit No. __ (LLS-10C), results in a total business enterprise value for Dex of BEGIN QWEST CONFIDENTIAL << [redacted] >> END QWEST CONFIDENTIAL

Q. Dr. Selwyn, you have pointed out that QCII's own financial advisors for the Dex sale had found the enterprise value of Dex to be BEGIN QWEST CONFIDENTIAL << [redacted] >> END QWEST CONFIDENTIAL than the sale price of $7.05-billion that QCII ultimately accepted from the Carlyle consortium. However, didn't both financial advisors supply fairness opinions that support the conclusion that the sale price reflected the full market value of Qwest's directory publishing business?

A. No, although Qwest apparently views the fairness opinions that way.[46] In reality, BEGIN QWEST CONFIDENTIAL << [redacted]

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45. Qwest Response to ATG 01-009, 10/28/02 Supplemental Response, Confidential Attachment A, at 16 ("Discounted Cash Flow Valuation").

46. *See* Qwest Response to ATG 01-022.

[redacted]>> END QWEST CONFIDENTIAL

Q. Please explain.

A. BEGIN QWEST CONFIDENTIAL<<[redacted]

[redacted]

[redacted]

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47. Qwest Response to ATG 01-005, Confidential Attachment C, at 12.

48. Qwest Response to ATG Set 1-022S1, Confidential Attachment A ("Lehman Brothers Fairness Opinion").

[redacted]

[redacted] [redacted]

[redacted] [redacted]

([redacted] [redacted]

[redacted] [redacted]

[redacted]

> [redacted]

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49. *Id.*, at 3.

[redacted]

[redacted]

[redacted] [redacted]

[redacted] [redacted]>>END QWEST CONFIDENTIAL

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50. *Id.*, at 4.

51. Qwest Response to ATG 01-022, Confidential Attachment B.

The sale of Dex at any distress price below its fair market value is detrimental to the financial health of QC and is not in the public interest.

Q. What is your overall conclusion concerning the relationship of the nominal sale price of $7.05-billion to the full economic value of the Dex business?

A. Based upon the evidence that I have discussed above, it is clear that the nominal $7.05-billion sale price BEGIN QWEST CONFIDENTIAL <<[redacted]>>END QWEST CONFIDENTIAL.

Q. How should this disparity between the proposed sale price and the potentially greater business enterprise value be treated by the Commission in this proceeding?

A. The business enterprise value of a going concern such as Dex reflects the net present value of the future stream of earnings expected to be produced by the activity. If Dex is sold for a price that is less than the full BEV, the cash produced from that sale will not be capable of producing a comparably large flow of earnings in an investment of comparable risk going into the future. Proceeding with such a sale would, all else being equal, have a detrimental impact upon the future financial condition of the seller. Of course, all else is not equal. QCII desperately needs cash, and a distress sale of Dex will produce cash. However, in Washington, the flow of earnings from the directory publishing activity inures to QC, currently via imputation, and *not* to QCII. Thus, if QCII is accepting a price for Dex that is below its fair market value in order to relieve QCII's cash shortage, then QCII will be compromising the long-term financial interests of QC.

As I have noted at the outset, this transaction as presently structured will fail to satisfy the "ratepayer indifference" public interest standard, and so should not be approved. However, as I shall discuss below, the "ratepayer indifference" standard could be satisfied if the structure and certain parameters of the transaction are modified so as to ensure that QC in Washington and its ratepayers continue to receive at least the same contribution from directory publishing as would occur absent the sale. Among other things, any such restructuring of the transaction would require that the full and fair market value of the Dex earnings stream be substituted, via imputation or otherwise, for the actual price that Buyer has agreed to pay to acquire Dex, and that the financial benefit from the sale transaction inuring to QC in Washington be no less than that which QC would receive under the existing Dex-earnings-based imputation arrangement.

Accordingly, if the Commission decides to approve the Dex sale, the starting point for a calculation of the compensation due to Washington ratepayers (which will, as I shall explain in the next section of my testimony, will also need to include a determination of the Washington share of the total 14-state Dex operation) must be based upon the total business enterprise value of the Dex operation, and *not* on the \$7.05-billion distress price that the Buyer has agreed to pay.

THE "RATEPAYER INDIFFERENCE" PUBLIC INTEREST TEST

Qwest's proposal to discontinue Dex earnings imputations after 2008 fails to provide Washington ratepayers with the full value of Dex's directory publishing business in Washington, and will thus make Washington ratepayers worse off than they would be if the sale does not take place.

Q. What is your understanding of Qwest's proposal for conferring a portion of the gains from the Dex sale to Washington ratepayers?

A. Ms. Jensen presents Qwest's proposal, which is "to continue imputation of directory earnings at its present value until the ratepayer interest in the sale proceeds is satisfied in 2008."[52] Specifically, Ms. Jensen observes that agreements entered into between parties in Docket No. UT-991358 limit the prospects for any increases to Qwest's regulated Washington rates before January 1, 2004.[53] Ms. Jensen states that, under its proposal, Qwest would agree to apply an annual imputation of Dex earnings of $103,370,843 if any rate case or earnings investigation is initiated between 2004 and 2008.[54] The $103,370,843 amount is Qwest's calculation of the last Commission-prescribed imputation amount, apparently updated to reflect growth in Qwest Corporation's Washington access lines.

52. Jensen (Qwest) Exhibit TAJ-1T, at 40-41 (page 41 revised on 2/14/03).

53. *Id.* at 41 (revised on 2/14/03).

54. *Id.*

Ms. Jensen interprets this arrangement as conferring the benefits from the sale transaction that are owed to ratepayers via a series of "revenue credits" applied each year of the period 2004 through 2008, such that the total compensation that Qwest deems Washington ratepayers are owed, BEGIN QWEST CONFIDENTIAL <<[redacted]>> END QWEST CONFIDENTIAL (pre-tax), would be received by ratepayers by 2008.[55] In the calculation presented by Ms. Jensen, this compensation scheme takes the form of an installment loan, in which the total liability (claimed to be BEGIN QWEST CONFIDENTIAL << [redacted]>> END QWEST CONFIDENTIAL), plus accrued interest, is "paid off" through four successive "payments" of $103.4-million in years 2004-2007, and a final "payment" of BEGIN QWEST CONFIDENTIAL << [redacted] >> END QWEST CONFIDENTIAL[56]

Q. Has this Commission previously rejected a prior proposal by the Company to interpret directory earnings imputations as an amortization of the total value of the directory business?

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55. Jensen (Qwest) Confidential Exhibit TAJ-4C (revised 2/14/02).

56. *Id.* The fact that the 2008 "revenue credit" would be only BEGIN QWEST CONFIDENTIAL <<[redacted] >> END QWEST CONFIDENTIAL introduces some ambiguity in the Company's proposal: E.g., if the Commission initiated an earnings investigation in the last few months of 2008, the Company might view the "installment loan" as being fully paid off, and thus assert that the appropriate imputation is zero rather than the full $103.4-million amount. This would appear to conflict with Ms. Jensen's characterization that "Under QC's proposal, should a review commence between 2004 and 2008, the amount of annual imputation to QC intrastate revenues will be $103,370,843." See Jensen (Qwest) Exhibit TAJ-1T, at 41 (revised 2/14/02), lines 16-18.

A. Yes, it did. In its 1998 petition in Docket UT-980948 for an accounting order to end the Commission's practice of imputing directory revenues, Qwest's predecessor USWC argued that Washington ratepayers had received full compensation for its alleged transfer of the entirety of the directory publication business, in the form of the accumulated value of past imputations of directory earnings.[57] In support of that argument, USWC "calculated the compensation as a principal and interest payment on the Washington portion of the value,"[58] which is the same calculation methodology that Qwest has put forth in the instant case. In its final order in that proceeding, the Commission expressly rejected that approach and the Company's assertion that imputations served as payments toward the value of the directory business:

> Imputation is thus an alternative to a distribution at the time of a transfer, when the transfer is to an affiliate. Its application to U S WEST has been to substitute the earnings imputation, for ratemaking purposes, for the actual payments (if any) by Dex for rights or services that USWC provides and that allow Dex to publish directories containing Yellow Pages advertising on behalf of USWC. That repricing of affiliated payments offsets the loss to ratepayers of the benefit they would have received if PNB had not transferred the business operation. *The loss to ratepayers occurs on an ongoing basis, and the offsetting benefit from imputation of "excess" earnings compensates ratepayers for the immediate period's loss, not for the capital value that might be distributed in the event of a sale to a third party in an arms' length transaction.*

57. Docket UT-980948, Direct Testimony of Ann Koehler-Christensen (USWC), October 16, 1998, at 4-14. See also, US WEST's Opening Brief, September 29, 1999, at 51.

58. Docket UT-980948, US WEST's Opening Brief, September 29, 1999, at 51. See also, in the same proceeding, Koehler-Christensen Exhibit AKC-2, which presents USWC's calculation of the alleged compensation ratepayers received from imputations.

> *Imputation is not a substitute for, nor is it a means to implement, the amortization of any value to be distributed.*[59]

Thus, the Commission has already decided this issue against Qwest. However, even in the event that the Commission were to consider Qwest's proposal, as an empirical matter Qwest's calculation does not support its claim that the Washington portion of the Dex sale proceeds would be "paid off" to ratepayers by year 2008.

In fact, under Qwest's proposal, there will be no adjustment to the existing imputation level during the 2004-2008 period *unless* the Commission is undertaking a review of QC's earnings:

> Under QC's proposal, ratepayers will receive the current value of the existing imputation of $103,370,843 (an increase of over $18 million or 21% of the value last set in Docket No. UT-970766) for the regulated results of operations each year until 2008. The benefit is received through calculation of the Company's results of operation and is most relevant when such results are formally reviewed as part of a rate case or earnings investigation. Under QC's proposal, should a review commence between 2004 and 2008, the amount of annual imputation to QC intrastate revenues will be $103,370,843. If all of the Company's retail services are competitively reclassified prior to 2008, imputation will essentially be terminated since the Company's rates will no longer be set through rate of return regulation.[60]

Indeed, it is entirely unclear as to how ratepayers receive *any* benefit from the Dex sale transaction. On the other hand, when under the QC proposal all imputation would cease after 2008, the Company would then be in a position to seek a rate increase of more than

59. *Yellow Pages Imputation Accounting Order,* at para. 173 (emphasis supplied).

60. Jensen Exhibit TAJ-1T, at 41-42.

$100-million to recover this loss of (imputed) earnings — and no matter how QC might try to portray such an event, ratepayers will be made worse off as a result.

Q. Earlier in your testimony, you stated that a threshold standard for whether Commission approval of the Dex sale transaction is in the public interest is that Washington ratepayers are not made any worse off as a result of the sale. Would Qwest's proposal to limit compensation to five additional years of imputation meet that standard?

A. No, it would not. If the sale were not approved, the baseline scenario is that the Commission's imputation process would continue indefinitely, to ensure that ratepayers receive the benefits deriving from the directory publishing function that the Commission has determined to be a "regulatory asset" despite the 1984 transfer of certain assets from the Company to Dex. The total value of those continuing imputations can be estimated by calculating the net present value ("NPV") of the stream of future anticipated imputation amounts. Table LLS-15HC attached to my testimony presents a calculation of that net present value, assuming annual imputations reflective of the earnings and EBITDA assumptions that Dex management presented in the Offering Memorandum distributed to potential buyers.

As I noted earlier in my testimony, in nominal terms (i.e., 2004 dollars), Qwest claims that its proposal would confer BEGIN QWEST CONFIDENTIAL << [redacted] >> END QWEST CONFIDENTIAL of compensation to Washington ratepayers. On that same basis (2004 dollars), my calculation shows that the NPV of the future anticipated imputations is

BEGIN QWEST HIGHLY CONFIDENTIAL << [redacted] >> END QWEST HIGHLY CONFIDENTIAL Clearly, Qwest's proposal fails to meet the threshold public interest standard of leaving ratepayers indifferent to the transaction, because in fact ratepayers would stand to lose compensation with a NPV of BEGIN QWEST HIGHLY CONFIDENTIAL << [redacted] >> END QWEST HIGHLY CONFIDENTIAL

Q. You stated that if the Commission decided not to approve the sale, that the default scenario would to continue imputations indefinitely. If the Commission approved the sale, is it a viable option to also simply continue the imputations process as a means of conferring the directory function's value to ratepayers?

A. Probably not. In the event the sale is approved and completed, Qwest's Washington directory assets would then have been transferred to an unrelated third party, the Buyer. Under the current arrangement, earnings realized by one QCII entity, Dex in this case, are effectively *transferred* to the regulated ILEC entity, QC; QCII's earnings overall are not affected by this imputation process. However, once Dex is no longer owned by QCII, there is no longer any basis for the Commission to impute this type of transfer of earnings from one affiliate to another. As such, the "imputation" would operate to create QC "earnings" in any given accounting period out of whole cloth, so to speak. The only practical means available to the Commission for assuring that such imputation of what amount to phantom earnings do not work to financially weaken QC is to require that actual cash be transferred by QCII into QC. And the time to do that is when QCII has the cash *in hand*, i.e., at the time that the sale of Dex closes and QCII receives a check from the Buyer.[61]

Given the historical growth trends for the yellow pages business in general and the Dex operation specifically, and Dex's favorable future prospects, Qwest ratepayers are not well served by a sale of Dex at this time.

Q. Have the Qwest and Dex Holdings witnesses advocating approval of the sale argued that selling Dex at this time is to the advantage of Qwest ratepayers?

A. Yes. Ms. Jensen testifies that "the sale ensures that Qwest captures the value of Dex now, receives fair value for the transaction, and avoids risk and uncertainty in the future."[62] Ms. Jensen further explains her views on the future "risk and uncertainty" for the Dex business as follows:

> Directory publishers have nondiscriminatory access to subscriber list information, and can otherwise compete for directory advertising revenues. All print publishing operations will face business risks, including price competition and competition from advertising in other media such as the Internet, in the future. Uncertainty about whether historic yellow pages revenues available for imputation will increase, decrease, or remain flat is avoided by selling the asset at this time..."[63]

61. Staff has suggested that under Washington law (RCW 80.16.010), a post-sale Dex could still be considered an "affiliate" of QC by virtue of the Publishing Agreement between the two entities. See Blackmon (Staff) Exhibit T-__(GB-T-1), at 20.

62. Jensen (Qwest) Exhibit TAJ-1T, at 4.

63. Jensen (Qwest) Exhibit TAJ-1T, at 39.

Similarly, Mr. Kennard opines on behalf of Dex Holdings that "Market trends do suggest, however, that the yellow pages business will become increasingly competitive, making that business more difficult to operate as a division of an ILEC."[64] According to Mr. Kennard, the sale benefits ratepayers because "Qwest customers no longer must assume this risk..." if the sale is completed.[65]

Q. What rationale does Qwest advance in support of its decision to sell Dex at this time?

A. The Qwest and Dex Holdings witnesses exaggerate the likely future competitiveness of the yellow pages industry, and the business and financial risks that Dex might face as a result of such competition in the future.

Q. Please explain why their portrayals of Dex's future risks are mistaken.

A. Ms. Jensen and Mr. Kennard are correct only in the very limited sense that, by selling the directory business, Qwest and its ratepayers would no longer incur *any* financial risk associated with the directory business for the utterly trivial reason that they would then not be participating in the directory business to begin with. However, the history of the yellow pages business over the past several decades, including the post-1984 period that Mr. Kennard specifically points to, is one of sustained growth in directory circulation,

64. Kennard (Dex Holdings, LLC) Exhibit WEK-1T, at 10.

65. *Id.*

advertising rates, revenues, and earnings. Indeed, it is particularly noteworthy that Mr. Kennard readily concedes that Dex's performance since 1984 has been very strong, and that ratepayers have in fact been much better off with retention of the business since that time than if it had been sold in 1984:

> As we know with 20/20 hindsight, Qwest would have received far less for the publishing business in 1984 than Dex Holdings is proposing to pay today. The relationship was obviously 'win-win' for Qwest and its local exchange customers, reflecting the growth of Dex since 1984.[66]

To the extent that Mr. Kennard and Ms. Jensen are suggesting that those risks are increasing or likely to increase in the future due to competition from the Internet or other print directory publishers, those arguments are overly simplistic and contradicted by Qwest's own financial projections for Dex, by the Lehman Brothers' analysis of Dex's market position and strategic options, and by the willingness of this very savvy Buyer[67] to pay more than seven billion dollars for the Dex enterprise.

Q. What did Lehman Brothers conclude concerning Dex's market position and strategic options?

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66. Kennard (Dex Holdings, LLC) Exhibit WEK-1T, at 10.

67. *Id.*, at 4-5.

A. BEGIN QWEST CONFIDENTIAL <<[redacted] >>END QUEST CONFIDENTIAL I have reproduced these documents as Highly Confidential Exhibit Nos. __ (LLS-13HC) and (LLS-14HC). While I encourage the Commission to review these documents in their entirety, several of Lehman Brothers' conclusions are particularly significant in the context of evaluating Dex's future prospects and its associated risks. These include the following:

BEGIN QWEST HIGHLY CONFIDENTIAL<<

[redacted]

[redacted]

68. Lehman Brothers, "*Qwest Dex at the Crossroads: Invest for Growth or Harvest and Decline"* (hereafter, "*White Paper*"), v4.9. Provided by Qwest in response to ATG 01-006.

69. Lehman Brothers, Qwest Dex Growth Strategy, August 2001 (hereafter, *"Growth Strategy"*). Provided by Qwest in response to ATG 01-006.

70. *Whitepaper* at 9.

71. *Growth Strategy* at 46.

[redacted]

[redacted]

[redacted].>>END QWEST HIGHLY CONFIDENTIAL In that context, Qwest's decision to sell the business in order to ameliorate QCII's financial crisis appears particularly ill-timed and unfortunate from a ratepayer perspective, because were it not for QCII's financial melt-down, the Dex asset could have been retained and

72. *Id.* at 48.

73. *Id.* at 2-5.

74. *Id.* at 5.

allowed to significantly appreciate in value, to the benefit of Qwest's ratepayers in Washington and elsewhere.

Q. Do you agree that it is to the advantage of Qwest ratepayers to sell Dex at this time?

A. No, I do not. As I have already explained in detail, the distress nature of the sale has forced Qwest to agree to a sale price that is BEGIN QWEST CONFIDENTIAL << [redacted] >> END QWEST CONFIDENTIAL than the business enterprise value of the Qwest assets that are to be sold. Indeed, if the Commission were to authorize the sale, it should impute the Washington share of the fair market value of the directory publishing assets, rather than simply the Washington share of the BEGIN QWEST CONFIDENTIAL<< [redacted] >> END QWEST CONFIDENTIAL sale proceeds, in order to properly compensate Washington ratepayers for loss of the "regulatory asset" of the directory business. That fact alone compels the conclusion that, from a ratepayer perspective, all other things being equal, ratepayers would be better served by retaining the Dex directory publishing operations at least until circumstances would allow a sale price to reflect the full enterprise value of the business.

Q. In order to make the sale eligible for approval, what valuation would the Commission need to impute for the purposes of determining the ratepayer share of the gain on the Dex sale transaction?

A. As I have noted, the net present value of the ongoing imputation of Dex earnings into the QC Washington revenue requirement is BEGIN QWEST CONFIDENTIAL << [redacted] >> END QWEST CONFIDENTIAL. Qwest currently determines the Washington share of Dex earnings by means of a *revenue-based* allocator of BEGIN QWEST CONFIDENTIAL << [redacted] >> END QWEST CONFIDENTIAL. On that basis, the *minimum* fair market business enterprise value that should be imputed for the Dex sale transaction is BEGIN QWEST CONFIDENTIAL << [redacted] >> END QWEST CONFIDENTIAL. As I shall explain later in my testimony, I believe that an *earnings-based* allocator is more appropriate, inasmuch as the imputation amount is itself linked to Dex's earnings rather than to its revenues. The earnings-based allocator to Washington is BEGIN QWEST CONFIDENTIAL << [redacted] >> END QWEST CONFIDENTIAL which, when applied to the BEGIN QWEST CONFIDENTIAL << [redacted] >> END QWEST CONFIDENTIAL net present value of continuing imputation, would indicate a minimum fair market business enterprise value for the entire Dex operation of BEGIN QWEST CONFIDENTIAL << [redacted] >> END QWEST CONFIDENTIAL. See Table 3 below:

75. See Table 3 below.

Table 3

Minimum Required Fair Market Value for Dex Sale Transaction

($-millions)	Revenue Allocator (Qwest)	Earnings Allocator (ETI)
NPV of imputations	[redacted]	
Washington allocator		
Contributed assets (WA portion)		
Cost of sale (WA portion)		
Total required sale proceeds/value		
Revenue-based allocator, using total directory operations:		
Washington	[redacted]	
All states		
Washington share of revenues:		
Source: Jensen (Qwest) Exhibit TAJ-3C		

As demonstrated in my Confidential Exhibit No.__(LLS-24C), using the BEGIN QWEST CONFIDENTIAL << << [redacted] >> END QWEST CONFIDENTIAL for the total Dex value, together with the earnings-based allocator, would produce the same level of benefit to Washington ratepayers as continuation of the current imputations process, so that the sale transaction could pass the "ratepayer indifference" public interest test.

WASHINGTON RATEPAYER ENTITLEMENT TO THE GAIN ON THE SALE OF DEX

Under the principles of the *Democratic Central Committee* decision, Qwest's ratepayers are entitled to benefit from the full gain on the sale of Dex, whose growth in value derives from its longstanding, integral relationship with the regulated, monopoly activities of the ILEC, whose business as a whole had itself enjoyed the benefit of ratepayer burden and risk.

Q. Dr. Selwyn, you have indicated that achievement of ratepayer indifference with respect to the sale of Dex would require that the financial value of the existing imputation arrangement for capturing Dex's earnings on its Washington directory publishing activities be maintained without any diminution. Is there a basis for conferring benefits upon ratepayers from the sale that would result in a net improvement over the current imputation arrangement?

A Yes. Although satisfaction of a simple ratepayer indifference requirement is all that is minimally required in order for the Commission to find that the transaction is in the public interest (or, more accurately, is not inconsistent with the public interest), QC's ratepayers may well be entitled to more than merely being made indifferent as a result of the sale transaction. In that regard, the Commission should apply the principles set forth in the landmark federal court decision, *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Transit Commission* (hereinafter, "*DCC*").[76] That case holds that "the right to capital gains on utility assets is tied to the risk of capital losses," and that "he who bears the financial burden of a particular utility activity should also reap the benefit resulting therefrom."

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76. *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Transit Commission*, 485 F.2d 786 (D.C. Cir.1973), *cert. den.* 415 U.S. 935 (1974).

Q. Based upon those principles, what is the ratepayers' entitlement to benefit from the gain realized by Qwest on the sale of its directory publishing activity?

A. As the court in *DCC* explains, the traditional ratemaking "practice in the utility field has long imposed upon consumers substantial risks of loss and financial burden associated with the assets employed in the utility's business." This has certainly been the case with respect to Qwest and its predecessors with respect to its Washington operations. At the same time, as observed by the Washington Supreme Court, "[i]t is an exaggeration to say [the ILEC's] shareholders took any significant risk in developing the directory publishing business, and we find that the public interest in those assets to be beyond dispute."[77] Therefore, ratepayers should receive that gain on the sale of the portion of its business that Qwest now seeks to sell to the Buyer.

Q. What about Qwest's position that the directory publishing business has never been a burden to ratepayers, because it has for many years generated revenues far in excess of the associated costs?

A. *DCC* specifically does not "carve up" a going business in this way. In the *DCC* case, the transit company acquired a going street railway (trolley) business that consisted of a collection of assets, including both depreciable assets (e.g., equipment) and non-depreciable assets (e.g., land). The transit company incurred significant costs, which it passed on to

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77. *U S West Communications, Inc. v. Washington Utilities and Transportation Commission*, 134 Wn.2d 74; 949 P.2d 1337; 1997 Wash. LEXIS 824, *38 (1997).

ratepayers, when it upgraded the street railways to a bus system. After the upgrades occurred, the transit company no longer needed certain parcels of land formerly used for storage and maintenance facilities associated with the trolleys and sold that land at a considerable gain. In fact, the court observed that land prices had risen steadily from when the transit company acquired the land (as part of its overall purchase) until the land was sold, creating no direct "risk" of loss to either ratepayers or shareholders. However, the court also found that ratepayers had borne a burden associated with the entire street railway acquisition, which had resulted in the need for significant fare increases. Similarly, while the part of Qwest's business associated with directory publishing activity has generally been profitable, it was acquired and successfully expanded as an integral part of the ILEC. Not every part of the ILEC's business was as profitable as the directory publishing activity, but ratepayers supported the entire package. Qwest attempts to isolate the directory publishing business, arguing that ratepayers are neither at risk or burdened by an identifiable portion of the business that is profitable. But ratepayers do not get to choose which (otherwise prudent) investments of the overall regulated telecommunications business they are required to support. The principle in *DCC* requires that regulators look at the *whole* business. Ratepayers, who bear financial burden associated with a whole assortment of interrelated utility investments, deserve to benefit when a portion of the regulatory assets of the business are sold at a gain.

Q. Is there any doubt that the business activity that Qwest proposes to sell is a "regulatory asset" and an integral part of its business?

A. No. Although Qwest insists on continually attempting to relitigate this, the findings of the WUTC over the past twenty years are clear and consistent. The Commission has found that "[the yellow pages publishing function is an *asset* of substantial value to Pacific Northwest Bell and as such should not be transferred under contract or otherwise to an affiliate without appropriate compensation." Moreover, it is clear that directory publishing was developed and grew as an integral part of the ILEC's franchised, local exchange telecommunications business.[78]

Q. What did the Washington Supreme Court conclude with respect to the claims of Qwest's predecessor, Pacific Northwest Bell, that the Yellow Pages business was a competitive enterprise that was unrelated to the Company's core business activity?

A. In its review of PNB's claims on appeal of the Commission's rate case order that required the continued imputation of Yellow Pages revenues, the Washington Supreme Court observed:

> The record shows that U S West did not develop this lucrative business by its initiative, skill, investment or risk-taking in a competitive market. Rather it did so because it was the sole provider of local telephone service, and as such owned the underlying customer databases and had established business

78. Before the late 1960s, "foreign attachments" to the actual telephone instrument were considered by some regulators to constitute an impermissible interference with telephone company property (see, e.g., *Carterphone vs. AT&T*, 13 FCC2d 420; 1968 FCC LEXIS 1269 (1968)), and some public utility commission took the position that plastic covers for telephone directories, distributed by would-be competitors for commercial and display advertising revenues, also interfered with the telephone company's property rights. Irwin, Manley R., *Telecommunications America*, Westport, CT, Quorum Books, 1984, at 28.

> relationships with virtually all of the potential advertisers in the yellow pages. Therefore, the Commission reasonably concluded that the yellow pages business is quite unlike businesses of other unregulated companies which were developed in, or derive their profitability from, the competitive marketplace. The record indicates that the billing and collection service provided to U.S. West Direct by U.S. West is a valuable business advantage to U.S. West Direct. The record also indicates that in contrast with potential publishing competitors, U.S. West Direct's publishing enjoys a unique and direct benefit by being associated with the Company's regulated telecommunications services.[79]

Q. Did this integral relationship end when the Commission authorized Qwest to transfer certain assets of the directory publishing activity to an affiliate, as of January 1, 1984?

A. No. As I discuss in greater detail below, the Commission plainly did not intend for the limited authorization for the transfer of assets to sever the relationship between the directory publishing activity and the ILEC. Perhaps more important in the context of DCC, however, is the fact that the transfer did not diminish the advantages, as described by the Washington Supreme Court in 1997, that the directory publishing activity derived by virtue of its association with the Company's regulated telecommunications business. Neither the average residential consumers who used Qwest's directories nor the businesses who purchased directory advertising would have seen significant changes that would have caused them to perceive that the directory publishing activity had been officially "de-linked" from the rest of QC's telecommunications business.

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79. *U S West Communications, Inc. v. Washington Utilities and Transportation Commission*, 134 Wn.2d 74; 949 P.2d 1337; 1997 Wash. LEXIS 824, (1997) at *36-37.

Q. Does Mr. Grate purport to apply the principles in *DCC* in coming up with his recommendation for how Qwest's gain on the sale of Dex should be allocated?

A. Yes, he does.

Q. Do you agree with his analysis and the conclusions he draws from it?

A. Not at all. I dispute Mr. Grate's analysis and conclusions in several key respects, including:

- the representation of the historical context for the ILEC's Yellow Pages business and its implications for determining ratepayers' entitlement to the gain on the sale of Dex;

- the characterization of 1983 Dex asset transfer and the prior regulatory actions of the Washington Utilities and Transportation Commission in this regard;
- the assumption that ratepayers' stake in the ILEC and its directory publishing activities stems exclusively from the ILEC's obligation to maintain the value of tangible depreciable assets; and, correspondingly,

- the characterization of the majority of the gain on the proposed sale as "goodwill" that, by virtue of not being reflected as an identifiable tangible asset on the Company's books, can be excluded from the value in which ratepayers have an interest.

For the whole of the time that Qwest and its predecessors have operated under state regulation in Washington, the directory publishing activity has been an integral part of the business supported by ratepayers.

Q. Please explain your objections to Mr. Grate's historical analysis of the directory publishing business of Qwest and its predecessors and the conclusions that he draws from this analysis.

A. First of all, I utterly disagree with Mr. Grate's attempt to create a directory publishing "pie" that goes back to the pre-regulatory period extant during the late nineteenth century. Even if his characterizations of the risk attendant to ratepayers vs. shareholders during the three historical periods he describes were valid, which they are not, I do not agree that the determination of risks/burdens under the *DCC* case can be translated into "risk-years," as Mr. Grate attempts to do here. Because Mr. Grate is attempting to allocate risk based upon the proportion of the directory business' "lifeline" that he attributes to its existence in either a "competitive" or a "noncompetitive" market, it is clearly in his interest to "pad" the so-called "competitive" years.

However, his construct fails on several grounds. First, the pre-regulatory period (before 1923) is irrelevant. Whatever risks were attendant to the directory publishing business (or, for that matter, the local telephone business overall) before the establishment of the ILEC's regulatory rate base were captured when it came under regulation. From that point on, the entirety of the utility's investment base — including its directory publishing operations — constituted the rate base upon which the utility's return on investment was determined. At that time, the shareholders of Qwest's predecessor (PT&T) agreed to be subject to earnings limitations in exchange for a government-protected monopoly franchise and the opportunity to earn a "reasonable" return on their investment. Moreover, during those early years, and before it became associated with the regulated telephone monopoly, the directory publishing business was a minute enterprise. Mr. Grate's attempt, therefore, to include those years as accounting for 40% of the "risk years" of the business, thus entitling shareholders to 40% of the gain on the sale, lacks a rational basis and is, in fact, transparently results-oriented.

Q. On pages 19 and 20 of his testimony, Mr. Grate purports to address the question of whether the risk of loss on the telephone company's assets was shifted to ratepayers upon their coming under regulation in 1923. What is your opinion of his analysis?

A. Mr. Grate resorts to an overly focused, technical interpretation of utility orders dating back to when the telephone company first came under regulation, addressing the treatment of *depreciable* assets at that time. Mr. Grate's core question in determining whether "risk" had shifted to ratepayers appears to be whether such ratepayers (in 1923 or thereabouts) would have been required to make up (through rate increases) the difference between the cost of replacing depreciable assets and the amount booked to the utility's depreciation reserve associated with the assets being replaced (through obsolescence or what Mr. Grate refers to as "catastrophic loss"). Mr. Grate is unable to conclusively answer this question as to utility practice in 1923, although he does admit that "[u]nder modern day mass asset accounting the utility [does] have the opportunity to recover even large losses through future depreciation."

Mr. Grate also seems to think that whatever risk ratepayers might have undertaken would arise exclusively from their obligation to maintain the utility's physical, depreciable assets. *DCC* requires the Commission to look at a business enterprise in a much more holistic manner.[80]

Q. Do you agree with Mr. Grate's conclusions with respect to whether ratepayers have borne a financial burden with respect to the ILEC's directory publishing activity from the time it came under regulation in 1923 until 1983, when U S West obtained permission to transfer certain physical assets associated with directory publishing out of the ILEC rate base, to be operated by an affiliate?

A. No, I don't. Mr. Grate concludes that while the imposition of rate of return regulation did indeed shift the financial burden of "telephone service operations" from investors to rate-payers, the fact that directory sales and advertising have always generated revenues that exceeded the associated expenses means that ratepayers were never "burdened." The determination of whether ratepayers have borne the burden associated with the incumbent LEC's directory business does not depend upon whether that particular business segment, on a stand-alone basis, has produced revenues in excess of the associated costs. Ratepayers

80. When Judge Greene directed that "[t]he assets used in the production of these printed directories will accordingly have to be allocated to the Operating Companies," [*Modification of Final Judgment*, U. S. v. AT&T, 552 F. Supp. 131, 212 (D.D.C. 1982) (hereinafter "*MFJ")*], he clearly was not referring to physical, depreciable assets alone. If all of the Yellow Pages intangibles (including the exclusive right to publish directories on behalf of the RBOC) had remained with AT&T and only the printing presses had transferred to Qwest, the outcome intended by Judge Greene would certainly not have been accomplished.

bear a burden associated with ensuring the financial viability of their incumbent local exchange carrier as a whole, not simply its individual components or services. Mr. Grate's theory would also lead to the conclusion that there was no risk or burden to ratepayers associated with each of the individual services (such as toll, carrier access, and vertical services) that Qwest and its predecessors have consistently priced above cost. Under this perverse view, only the unprofitable segments of the ILEC's business could be tapped as a potential source of "gain."

Q. What, if anything, is wrong with Mr. Grate's characterization of the last 20 years of the directory publishing activity, after US West's decision in 1983 to transfer certain tangible assets associated with that business to its Dex affiliate, and the conclusions he draws with respect to them?

A. Mr. Grate greatly exaggerates the changes in regulatory and market conditions and their effects on Qwest's position as the dominant supplier of white and Yellow Pages directories. The divestiture of the Regional Bell Operating Companies from AT&T in 1982 did nothing consequential to diminish the monopoly power within the RBOCs' local exchange carrier or directory publishing businesses, and neither did the various legislative and legal changes referenced (mostly in general terms) by Mr. Grate. As I will discuss below, and the investors' report confirm, consumers' perception of the integral relationship between the Yellow and White pages directories and the ILEC has continued to be strong and to permit Qwest to maintain its near-monopoly position in this line of its business.

Q. Mr. Grate asserts earlier in his testimony that "customers who have competitive choice [do not] bear any burden of cost recovery." Do you agree?

A. Without agreeing that Qwest's directory publishing activity is competitive,[81] the answer is still no. So long as a competitive activity remains part of a rate of return regulated entity, it shares in the burden of cost recovery. Whether or not an individual product or service generates more or less revenue than the associated costs directly affects the prices that rate-payers are obligated to pay for other utility services. It's a package deal.

The 1984 transfer did not fundamentally change ratepayers' interests and obligations with respect to the directory publishing activity.

Q. Did the January 1, 1984 transfer of certain assets from (then) US West Communications (USWC) to an affiliate fundamentally change ratepayers' interests and obligations with respect to the directory publishing activity?

A. No, it did not. Through the testimony of Mr. Grate and Ms. Jensen, Qwest has launched a collateral attack on the Commission's Orders that expressly limit the scope and intended consequences of the decision, in 1983, to permit Qwest to transfer certain assets associated with its directory publishing activity to an affiliate. Qwest has tried this tack before,

81. In fact, at note 256 of the *Modification of Final Judgment*, the federal court stated: "It does not even seem to be true that, as the Department of Justice assumes, the Yellow Pages fall as a purely formalistic matter on the competitive side of the monopoly-competition dichotomy. See, e.g., Telecommunications Act of 1982 Hearings, supra note 141, at Part 1, pp. 551-52." *MFJ*, 552 F. Supp. 131, 209.

unsuccessfully. In its *Yellow Pages Imputation Accounting Order* this Commission held unequivocally that "the Yellow Pages publishing activity has not been transferred permanently to USWC's affiliate for regulatory purposes."[82] The Commission found, more specifically, that, consistent with representations made by U S West in 1983, the intangible assets associated with the Yellow Pages activity did not transfer to its affiliate.[83] The Commission reiterated that no part of the business not specifically mentioned in 1983 Order had been transferred and it went so far as to declare "void" any reliance upon the decision as authorizing the disposition of any part of USWC's business beyond the specific physical assets that PNB had asked to have transferred to the affiliate for the purpose of publishing directories and Yellow Pages on PNB's behalf.[84] As it has done repeatedly in the past with respect to Yellow Pages imputation, Qwest is rearguing matters that have been conclusively addressed and disposed of by the Commission.

Q. When the Commission expressly limited QC's authority regarding the transfer of directory publishing to certain limited depreciable property, did this decision preserve the interests of QC and its ratepayers the corpus of intangible assets that represent the core value of the directory publishing business?

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82. *Yellow Pages Imputation Accounting Order* at para. 19.

83. *Id.,* at paras. 113-114, 168.

84. *Id.,* at para. 163-169.

A. Yes, and I might add, since nothing but the specified depreciable assets was legally transferred out of QC to a non-regulated affiliate, QCII has no rights, independent of QC, to sell anything but those depreciable assets to a third party buyer.

The Commission is not required to allocate a portion of the gain on the sale of Qwest's directory publishing business to Qwest shareholders.

Q. Are you familiar with this Commission's decision in the *Centralia Power*[85] case?

A. Yes. That case involved the sale of coal-fired power, which was owned jointly by several Washington electric utility companies. Based on its view of the circumstances in that particular case, the Commission, citing the principles in DCC, made the decision to split the gain on the sale of the power plant equally between ratepayers and shareholders. A dissenting Commissioner recommended that ratepayers receive 100% of the gain.

Q. Does the Commission's decision in the *Centralia* case stand for the proposition that the gain on a sale must be split between ratepayers and shareholders?

A. No. The Commission made it clear that each application of the principles in DCC is determined by the facts in the particular case. In *Centralia*, the Commission found that a sharing of benefits would be appropriate under circumstances where it could be established

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85. *Applications of Avista Corporation et al. for Authority to Sell Interests in the Coal-Fired Centralia Power Plant*, Docket Nos. UE-991255, UE-991262, UE-991409, Second Supplemental Order, Approving Sale with Conditions, March 2000.

that ratepayers and shareholders shared the risks of loss, or, alternatively, jointly bore the burdens associated with the regulatory assets being sold off; based on the facts, as it saw them in the *Centralia* case, the Commission made a finding that there was a shared risk/ burden involved. However, the Commission certainly was explicit in holding that the application of the DCC principle must be done "not based on a pre-conceived formula, but on the equities of [each] distinctive case." This point is also made a length in the DCC case itself. As I have explained, the circumstances under which the directory publishing activity have developed, as an integral part of the ILEC's ratepayer-supported telephone business, establish a strong claim by ratepayers to the gain that Qwest will realize on the sale of Dex.

Q. Does the Commission's rationale in *Centralia* for ordering a ratepayers and shareholders get an equal share of the gain make sense under the circumstances of the present case?

A. It does not. In *Centralia*, the Commission seems to have found that was "risk" to shareholders as well as to ratepayers in the joint owners' decision to sell off the Centralia plant (as market uncertainty could, in hindsight, prove the decision either favorable or not), and that the owners needed to be rewarded for pursuing the sale (based on their best managerial judgment) by knowing that they would share in the gains. This analysis proceeds somewhat differently from the typical application of the DCC principles, as it seems to focus more upon the risks attendant to the decision to sell, rather than to the ongoing risks and burdens that had been shouldered by ratepayers (vs. shareholders) while the utility held the assets in question. Even if one were to apply DCC in this manner, which I do not advise, *Centralia* reflects a very different set of circumstances than the proposed Dex sale. The decision being made by Qwest to sell off its directory publishing activity does not appear risky from the perspective of its shareholders, nor can it be plausibly argued that the decision to sell of the directory business will (as the Commission perceived the sale in *Centralia*) "minimize rates, and best serve both ratepayers and shareholders." Indeed, in the case of the Dex transaction, its sale by Qwest will decrease shareholder risk (by diminishing the potential for bankruptcy of the parent company) while simultaneously increasing both ratepayer risks and burdens, by putting a premature end to the ongoing imputation of excess Dex earnings into the QC-Washington revenue requirement. Hence, the facts attendant to the Dex sale transaction are virtually 180 degrees apart from those associated with the *Centralia* situation.

The ratepayer interests in the value of the directory publishing business is not limited to its depreciable assets, but in any case, virtually all of the intangible value that Qwest proposes to sell to the Buyer actually resides in QC, not in Dex.

Q. At page 24 of his testimony, Mr. Grate asserts that "the majority of the gain on the sale of Dex is attributable to goodwill; its depreciable assets make up a small fraction of its value;" and he continues, "no allowance for depreciation or amortization of that goodwill has ever been allowed in the Company's rates." Is the principle in *DCC* limited to depreciable assets?

A. It is expressly not so limited. The court in *DCC* soundly rejected the position that "gains on nondepreciable assets inure to investors only." The court stated that "farepayers' equities founded upon their assumption of the remaining economic responsibilities ... and upon investors' enjoyment of especially-conferred advantages not available to others [i.e., associated with the monopoly franchise], are precisely the same whether the source of gain is depreciable or nondepreciable property."[86]

Q. Does the Dex sale include only Dex assets?

A. BEGIN QWEST HIGHLY CONFIDENTIAL<< [redacted] END QWEST HIGHLY CONFIDENTIAL

Q. BEGIN QWEST CONFIDENTIAL<< [redacted] END QWEST CONFIDENTIAL

86. DCC, at *821.

87. Purchase Agreement, at 1 (WA 000565); provided in Qwest Response to ATG 01-006 (Highly Confidential).

88. Qwest Corporation Joinder for Rodney Purchase Agreement, WA 001360; provided in Qwest Response to ATG 01-006 (Highly Confidential).

89. *Id.*

A. BEGIN QWEST HIGHLY CONFIDENTIAL<<[redacted]END QWEST HIGHLY CONFIDENTIAL

Q. Dr. Selwyn, as you are aware and as we have been discussing, the WUTC has determined that Qwest's directory publication activities in Washington are regulatory assets of QC, and that Dex's role in the preparation and publication of Qwest's Washington directories is in essence an outsourcing function under the terms of the Publishing Agreement between QC and Dex. In that regard, is there any property that this Commission has determined to be QC assets that is being included in QCII's sale of Dex?

A. BEGIN QWEST HIGHLY CONFIDENTIAL<<[redacted]END QWEST HIGHLY CONFIDENTIAL In its 2000 ruling, the Commission specifically found that only the "tangible" assets had been transferred, while all intangible value, not paid for by Dex, was retained by (then) US West, with Dex compensating ratepayers through publishing fees and later imputation of all excess Dex earnings arising out of its Washington directory publishing activities. The full value of the QC intangibles that had been "outsourced" to Dex was deemed by the Commission to be regulatory assets of (then) US West.[90] On that basis, the Commission determined that the excess profits generated by Dex from its

90. *Yellow Pages Imputation Accounting Order*, at paras.154, 158.

Washington directory publishing activities should continue to be included in determining (then) US West's Washington intrastate revenue requirement, via a continuing imputation of such excess profits to QC's Washington intrastate earnings.[91]

Q. How are "intangible"assets distinguished from "tangible" assets?

A. *Tangible* and *intangible* assets — together with cash and other *financial* assets are, by definition, collectively exhaustive constitute the "going concern" value. Tangible assets are physical assets, such as plant and equipment, land and buildings, used by the company in the course of conducting its business. In the case of Dex, the book value of its tangible assets amounts to approximately BEGIN QWEST CONFIDENTIAL <<[redacted]>> END QWEST CONFIDENTIAL is associated with its Washington directory publishing activities.[92] Intangible assets are those other elements of a business enterprise that enable it to produce revenues and profits, assets that exist in addition to the firm's financial and tangible assets.[93] Intangible assets include, *inter alia*, the firm's embedded customer base, accumulated customer loyalty, brand name recognition, trademarks and rights thereto, patents, trade secrets, customer lists, databases, know-how, licenses, an experienced workforce, and the like.

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91. *Id*., at 187.

92. Jensen Exhibit TAJ-2C, using the Dex Washington vs. fourteen-state earnings-based allocator I discussed earlier.

93. The Intangibles Research Center, Vincent C. Ross Institute of Accounting Research, New York University Stern School. Available at: http://www.stern.nyu.edu/ross/ProjectInt/.

Q. Mr. Grate defines "the intangible asset" transferred in this sale as "Dex's goodwill."[94] Do you agree that "Dex's goodwill" is the relevant intangible asset in this case?

A. No. Goodwill is certainly one of the intangible assets involved in this transaction, but in this case Goodwill is a minor element of the overall value of the transaction. Even more important, for the most part whatever "goodwill" is actually being sold by Qwest in this transaction is actually an asset of QC and is being "donated" by QC to the Rodney Sale. Mr. Grate has attempted to portray the assets included in the Dex sale as being either tangible assets (such as property, plant, and equipment) or "Goodwill." Mr. Grate defines "Goodwill" as "the customer or patronage of any established trade or business; the benefit or advantage of having established a business and secured its patronage by the public." In fact, the correct distinction is the one that he made earlier, the distinction between tangible and intangible assets; goodwill is merely one among many categories of intangible assets, and thus constitutes only one part of a company's intangible value.

Q. Why it is important to distinguish between various intangible assets apart from "goodwill" for purposes of the issues before the Commission in this proceeding?

A. Based upon his definition of Goodwill as comprising all of the intangible value of Dex, Mr. Grate claims that "[m]ost of the gain on the sale of Dex is attributable to Dex's goodwill"[95]

94. Grate (Qwest) Exhibit PEG-1T, at 17.

95. *Id.*, at 17.

which, he claims, is not a “regulatory asset” of QC and as such Qwest has no obligation to flow-through or otherwise share the ‘goodwill” portion of the proceeds of the Dex sale with QC’s ratepayers. With this claim, Mr. Grate obscures what is actually happening in two crucial ways. First, he ignores what I will refer to as QC’s “identifiable intangibles” contributed to the sale, and the significant uncompensated value they represent. Second, by ignoring these identifiable intangibles, Mr. Grate obscures the relationship between QC’s identifiable intangibles and the franchise value enjoyed by Qwest Dex. In fact, *practically the entire value that Mr. Grate refers to as “Dex’s goodwill” actually consists of identifiable intangibles and their directly resulting “Franchise Value” that this Commission has previously determined to constitute “regulatory assets” beneficially belonging to Qwest Corporation, and as such should continue to be treated for regulatory purposes as assets of QC.*

Q. Please explain the differences among the concepts of “identifiable intangibles,” “franchise value” and “goodwill.”

A. The best way to think about intangible value is in terms of separability. If a certain asset can be separated from a business and sold on a stand-alone basis, that intangible qualifies as an either an identifiable intangible or "franchise value" and therefore is separate from "goodwill". There are several sources of separability, depending upon the specific asset in question.

We can look for specific guidance in this area to the Financial Accounting Standards Board ("FASB") as well as to the US Internal Revenue Service ("IRS"), both of which have promulgated standards and regulations pertaining to the treatment of intangible assets.[96] First, as the FASB explains, an "identifiable intangible asset" can arise from a legal right.[97] Trademarks, patents, licenses, and certain broadcasting and mineral rights are all common examples of assignable, separable, legal rights to intangible assets. An owner of these assets can either leverage the asset itself or sell the asset based upon the market valuation of the future economic benefit associated with the use of the asset to generate future revenues. For example, if a research pharmaceutical firm owned a patent on a new drug, the legal rights to that drug afford the firm several options. First, the company could utilize the patent itself and begin manufacturing the drug, thus realizing over time the patent's earning potential. Second, the company could sell all rights in the patent to a manufacturer, which would pay a price for the patent based upon the future earnings that it expects to realize from the sale of patented drug. Third, the company may license the patent to several manufacturers, each with the right to manufacture the drug, but retain ownership of the patent, with the price of such licenses also being driven by the potential earnings that each licensee can expect to generate therefrom. Conversely, a firm might license a patent, trademark or other intangible asset from its owner on terms that are either not (or no longer) available to other potential rivals and that enable it to generate profits over time. The possession of such

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96. Financial Accounting Standards Board, "Statement of Financial Accounting Standards No 141 and 142, June 2001; IRS Publication 535 (2002 version).

97. FASB 141, at 27-28.

rights to intangibles owned by others is itself an intangible asset that confers value upon an enterprise.

Significantly, separable intangible assets do not necessarily have to stand alone in order to be considered separable for valuation purposes. As the FASB notes, "an intangible asset that cannot be sold, transferred, licensed, rented, or exchanged individually is considered separable if it can be sold, transferred, licensed, rented, or exchanged in combination with a related contract, asset, or liability."[98] Take the drug manufacturing example from above. Eli Lilly owns both the trademark and the right to manufacture "Prozac" the well-known anti-depression medication. By virtue of its legal rights, Eli Lilly can license to alternative manufacturers either the right to use the "Prozac" trademark, or the right to manufacture the patented formula for Prozac (released as a generic drug under a different name). In either case, the rights licensed would be valuable. Alternatively, Eli Lilly would be able to assign both the "Prozac" trademark and the patent to a buyer, while ceasing its own Prozac manufacturing activities, and thereby separate from itself its entire market share related to the sale of "Prozac." Such an assignment would effectively separate the entire value of the drug from Eli Lilly to the buyer without entailing the sale of the Lilly business itself, and represent what I have called the "franchise value" of the drug called Prozac, and would thus constitute additional value on top of the trademark or patent value.

98. *Id.,* at 12.

These separable assets are clearly different from an intangible such as "satisfied customers." A company has no reliable or practical means to assign a customer's positive relationship with the company to a third party except through the sale of the entire enterprise. Similarly, where the additional value of a property exists because the property is an integral part of an established business, the relationship cannot be separated from the business as a whole. The value of non-separable intangibles is the goodwill and going concern value.

Q. Is this distinction between identifiable intangibles and goodwill a common one?

A. Yes. Both the IRS and FASB statement No. 141 require, for the purposes of amortization and depreciation, that a company separately account for identifiable intangible assets and goodwill. I previously explained some of the requirements applied by the FASB. The IRS defines a lengthy set of intangibles including, *inter alia*, Goodwill, Going concern value, computer software, patents, copyrights, a covenant not to compete entered into in connection with the acquisition of an interest in a trade or business, a franchise, trademark, or trade name.[99]

Most of the "intangible assets" *including goodwill* that are being sold by Qwest in this transaction were determined by the Commission to be assets of QC, not Dex.

Q. Earlier you stated that a number of *QC-contributed intangible assets* are being included in the Purchase Agreement. To what specific QC assets are you referring?

99. IRS Publication 535, "Business Expenses" 2002 Version, at 36. (Available at: http://www.irs.gov/pub/irs-pdf/p535.pdf)

A. A list of QC transferred assets is included in Exhibit No. __ (LLS-16HC) to my testimony. BEGIN QWEST HIGHLY CONFIDENTIAL<< [redacted] The items conveying the most value, however, are included in the Purchase Agreement as separate Exhibits. Several of the Exhibits to the Purchase Agreement, such as the Publishing Agreement (Exhibit D), the Non-Competition Agreement (Exhibit M), and the Expanded Use List License Agreement (Exhibit F),[100] constitute significant identifiable intangible assets. Each are Agreements valuable to numerous competitive directory publishers, with whom, had QC not "contributed" the asset to the Dex sale, QC would have been able to sell to competing directory publishers for significant prices.

BEGIN QWEST HIGHLY CONFIDENTIAL

[redacted]

100. Provided in Qwest Response to ATG 01-006 (Highly Confidential).

[redacted]

[redacted]

[redacted] END QWEST HIGHLY CONFIDENTIAL

Q. Has the Commission previously addressed the ownership and value of the identifiable intangibles that QC is contributing to the sale transaction?

A. Yes, as I have previously discussed, the Commission has addressed the issue of the transfer of the Qwest directory publishing business on several previous occasions. In each of these rulings, the Commission has found that the publishing rights and other intangible assets owned by QC (and its predecessors) are valuable assets the benefits of which are to flow to Qwest's monopoly services customers in Washington State. When Qwest (then Pacific Northwest Bell ("PNB")) first applied to the Commission for transfer of its directory advertising business at the time of the break-up of the former Bell System, it agreed to the payment of publishing fees by the Company's yellow pages affiliate (U S WEST Direct) in exchange for the rights to publish PNB's directories. The Commission described that earlier ruling in its *Yellow Pages Imputation Accounting Order*:

> [The Commission in the 1984 ruling had found that]... the transactions between PNB and U S WEST Direct were not arms' length dealings, and stated its concern that PNB not undervalue the advertising revenues in the publishing agreement with its affiliate. The Commission reserved the right to determine reasonable revenues and expenses, together with their proper regulatory treatment, in any formal proceeding before the Commission dealing with the results of U S WEST's operation for ratemaking purposes. The Commission directed PNB to record and maintain all records needed to perform the eventual valuation.[101]

Further Commission Orders required payment of publishing fees for the rights granted by the 1984 Publishing Agreement, concluding that "[the fees were established and represented as compensation for the rights to perform that activity and for other services rendered by PNB."[102]

The Publishing fees were subsequently supplanted by imputation requirements, which themselves were applied as a result of USWC's retention of its rights (and the subsidy those rights represented for local ratepayers) to its directory publishing business. As the Commission stated:

101. *Yellow Pages Imputation Accounting Order*, para. 27, citing *re PNB Tel. Co.*, *Order Granting Application in Part, No. FR-83-159, (December 30, 1983), p. 2.*

102. *Id.,* at para. 181.

> Imputation is thus an alternative to a distribution at the time of a transfer, when the transfer is to an affiliate. *Its application to U S WEST has been to substitute the earnings imputation, for ratemaking purposes, for the actual payments (if any) by Dex for rights or services that USWC provides and that allow Dex to publish directories containing Yellow Pages advertising on behalf of USWC.* That repricing of affiliated payments offsets the loss to ratepayers of the benefit they would have received if PNB had not transferred the business operation. The loss to ratepayers occurs on an ongoing basis, and the offsetting benefit from imputation of "excess" earnings compensates ratepayers for the immediate period's loss, not for the capital value that might be distributed in the event of a sale to a third party in an arms' length transaction.[103]

Any suggestion (as made by Mr. Grate) that the ratepayers of Washington State are not owed compensation for the publishing rights as set forth in the Publishing Agreement ignores the substantial history and precedent of this Commission relating to publishing fees and imputation requirements. The fact that the Commission has repeatedly ordered that ratepayers receive the full value of the rights granted to Dex (and its predecessors) in the Publishing and other agreements undermines and refutes any suggestion that the ratepayers should not receive the full value of the rights granted to the Buyer in the Publishing and other agreements.

Moreover, and notwithstanding the Commission's prior determinations as to QC's continuing ownership of the Washington yellow pages business, an analysis of the components of the sale transaction and the sources of value of the asset being sold by QCII confirms that such value principally arises out of assets that are *unambiguously* the property of QC, and not of Dex. Indeed, this same condition would hold even in other Qwest states in

103. *Id.,* at para 173, emphasis added.

which the state PUC has not made the explicit determinations that this Commission has in its previous Yellow Pages rulings.

The identifiable intangibles included in the Qwest sale, as an economic matter, derive their value from the QC's position as the legacy franchised monopoly provider of basic local exchange telephone service.

Q. Why does the value of Qwest's directory publishing activity reside in QC rather than in Dex?

A. The value of Qwest's yellow pages publishing operation is intimately tied to its position as the legacy franchised monopoly provider of basic local exchange telephone service and its ongoing overwhelming dominance of the local exchange telephone service business in its operating areas throughout the 14-state Qwest region. This fact is confirmed by the extreme importance that the Buyer has ascribed to the relationships that will persist *post-sale* between QC (in all fourteen states) and Dex. BEGIN QWEST HIGHLY CONFIDENTIAL [redacted]

[redacted] END QWEST HIGHLY CONFIDENTIAL

104. Purchase Agreement, Exhibit D Publishing Agreement, at 25 (WA 000729); provided in Qwest Response to ATG 01-006 (Highly Confidential).

As such, the Agreements provide significant value to the sale — value contingent upon Agreements with Qwest Corporation, rather than with the Qwest parent or with Dex.

Q. Are you able to estimate the worth of the identifiable intangibles listed above that are actually owned by QC that are to be included by the Qwest parent in this sale?

A. Intangibles are notoriously difficult to value, a fact that the Commission noted as early as 1916.[105] FASB standards and the IRS only value internally generated intangibles at the time of sale, since without the sale (or comparable sales), it would be difficult to ascertain the arms-length value of a unique intangible. In the case of the Publishing Agreement and the Non-Competition Agreement, the proposed contracts between the Buyer and QC contain language indicating that, as cited above, BEGIN QWEST HIGHLY CONFIDENTIAL << [redacted] >>END QWEST HIGHLY CONFIDENTIAL As such, a strong case exists that the these document are extremely valuable. The Publishing Agreement is an asset that the Washington operating telephone company had previously licensed to Dex[106] and for which it had been compensated via imputation, thus the full value of these new Agreements should similarly flow to ratepayers as a *replacement* for the current imputation.

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105. This fact is noted by Qwest as well. Grate (Qwest) Exhibit PEG 1-T, at 16.

106. BEGIN QWEST HIGHLY CONFIDENTIAL<< [redacted] >>END QWEST HIGHLY CONFIDENTIAL See list of excluded assets, Purchase Agreement, Exhibit B Contribution Agreement, at Schedule 2.2 (WA 000663), provided in Qwest Response to ATG 01-006 (Highly Confidential).

Q. Does the value represented by the Publishing Agreement and the Non-Competition Agreement stand alone as the full value of QC transferred intangibles included in the Washington portion of the Dex sale?

A. No, it doesn't. QC is also contributing the "Franchise Value" of dominant market share associated with the legacy history of the Dex business.

Q. What is the difference between what you've called "Franchise Value" and what Mr. Grate refers to as "Dex's goodwill"?

A. As normally considered, "goodwill" is the market power that a firm accumulates based upon past advertising, customer service, and customer loyalty. An example would be a neighborhood pharmacy. A pharmacist with a history of serving a community, taking the time to explain medication and recommend over-the-counter medicine or who will keep the store open a few minutes late if a customer is running late will doubtless accumulate a loyal customer base even in the fact of competition from large chains. The customers he acquired through this service would represent the "goodwill" value of his pharmacy, but would likely only be transferable to another small, community-minded pharmacist. If the pharmacy were purchased by a large chain drug store, there is no reason to believe that the customer base would remain loyal, essentially eliminating the "goodwill" value of the pharmacy. Moreover, unless the building in which the store is located is owned by the store itself or is subject to a long-term lease, even that "geographic goodwill" may have little or no transferable business enterprise value.

Alternatively, the type of "Franchise Value" that Qwest Dex enjoys does not result from stellar customer service or exceptional qualifications, but rather from QC's history as the monopoly provider of basic local exchange telephone service and its associated protected monopoly directory publishing activities, and the legacy market share that persists from that historic condition even now that limited competition (both in the local telephone business and in the directory publishing business) is present. That legacy market share is a direct result of (1) Dex's "first mover" advantage arising out of the historic QC local phone service monopoly and the historical and ongoing relationship between QC and Dex, with QC designating Dex as the "official publisher" for which Dex has either paid publishing fees or compensated ratepayers via imputation, and (2) advertising and other marketing activities undertaken by Dex as part of its obligations under the Publishing Agreement with QC. The costs of publishing fees are typically expensed and thus not carried on a company's books, even though *from an economic perspective* such costs could be properly characterized as *investments* capable of producing returns *over time*. In that sense, the book value of the enterprise is itself understated because various investment outlays made in the past were not capitalized and are thus not captured on the firm's balance sheet.

Even if a rival firm might potentially make a similar investment for the purpose of capturing customers away from the firm in question (as the Buyer would be forced to do without the acquisition of Dex market share), the entrant would not have the "first mover" advantage and in any event would require an extended period of time to acquire a comparable customer base, if it could be accomplished at all. Finally, if the nature of the firm's activities involves significant *network externalities* (which is decidedly the case with yellow page directory advertising), replication of the "first mover's" embedded customer base would be all but impossible.

Q. What are "network externalities?"

A. Network externalities exist where the demand exhibited by individual consumers for a given product or service is heavily influenced by the actions of other consumers with respect to the product. I am more likely to place an item for sale on eBay than on other Internet auction sites because eBay attracts more visitors than any other Internet auction site. And the reason that eBay attracts more visitors is because eBay carries more auctions. Significantly, eBay's head start was just a few years earlier than other Internet auction sites, yet no rival has ever been able to penetrate its formidable market dominance. Even Amazon.com, which itself enjoys considerable market presence as the preeminent Internet "store" and which several years ago also started an Internet auction site, has nevertheless had very little impact upon eBay's dominance of the Internet auction business.

As I have discussed at length in my testimony in WUTC Docket UT-980948, the yellow pages directory advertising business is heavily impacted by these same types of network externalities. The reason for this phenomenon can best be explained by thinking of services like eBay, yellow pages directories, classified advertising sections of newspapers, and the like, as each performing a "switching" or an "exchange" function, bringing advertisers together with buyers and transferring information from the former to the latter. The demand exhibited by individual advertisers and consumers for a particular yellow pages directory, like that for many other products and services that perform switching or exchange functions, is heavily influenced by the actions of other advertisers and consumers with respect to the product.

In economic theory, such demand is said to be influenced by "externalities;" that is, one's demand for access to the "information exchange" function supported by a given yellow pages product is heavily influenced by the aggregate number of *other* advertisers and users who participate in the exchange. Advertisers are more willing to advertise in, and pay higher rates for, directories with large, perhaps ubiquitous circulation; consumers are more likely to select the directory that has the largest compilation of listings and advertisements. No competing directory publication comes even close to the level of user acceptance and penetration that can be found in the incumbent ILECs' book. Moreover, each time a business decides to include its listing in the directory, it increases the value of the directory to all consumers and makes it all the less likely that consumers will elect to use a competing book. Indeed, ILECs are constantly promoting precisely this characteristic of their yellow pages directories.

Q. What is the source of the "network externalities" that exist in the case of Dex?

A. Dex was a protected monopoly "first mover." While eBay's enjoyment of significant network externalities arises through its early entry into the Internet auction business and its development of a user friendly and accessible website[107] that led to its "first mover" advantage, the Dex "first mover" advantage results from the years that it operated as the Commission-protected sole yellow page publisher in Washington State, linked to the monopoly local phone company. This protection specifically removed the "risk" faced by Dex, and effectively ensured that, regardless of the quality of the Dex sales team, customer service, or any other aspect of the Dex operation, business interested in yellow pages advertisements, Dex enjoyed network externalities that would ensure its continued market dominance even following the development of competitive directories.

Q. You stated earlier that one of the intangibles separable from the Dex business is the "franchise value." With what intangibles is the Franchise Value associated?

A. The Franchise Value relates to the Publishing and Non-Compete Agreements, both an assignable right owned by QC due to the company's position as the dominant local exchange carrier in the state. The Franchise Value *follows* the value of these agreements due to user *impression* of the directory's association with the ILEC. The aspects of a directory that lead to a customer's use of the book — impressions that it is "the most complete" or the "official" directory — give rise to the customer's loyalty to the book, and that loyalty will transfer to any future book with the same associations. These aspects of the current Qwest yellow page directories that encourage customer use are transferred to the

107. See, Brad Hill, "What Makes eBay Invincible," *Ecommerce Times,* March 4, 2003, available at: http://www.crmdaily.com/perl/story/20900.html, Provided in Exhibit No. __(LLS-17).

Buyer in the Publishing and Non-Compete Agreements — agreements between the Buyer and QC that bypass Dex and the Qwest parent altogether. For example, the Branding Exhibit to the Publishing Agreement provides that: BEGIN QWEST CONFIDENTIAL <<

[redacted]

[redacted].>> END QWEST CONFIDENTIAL Qwest's (and USWC's and PNB's) historic monopoly over local exchange telephone service within its operating areas resulted not from any entrepreneurial risk-taking on the part of the Company's investors (as, for example, is the situation with eBay) but instead from an affirmative decision by the Washington legislature and the Washington Utilities and Transportation Commission (and its predecessor agencies) to confer an exclusive franchise for the provision of local telephone service upon (then) Pacific Telephone and Telegraph Company.[109] The "first mover" advantage enjoyed by Dex and its predecessors in the Washington yellow pages directory business, and which it now proposes to sell to the Buyer, arose directly and specifically from that monopoly local exchange telephone service franchise. Contrary to Mr. Grate's portrayal, the value of Dex's directory business in Washington State has no independent source for its existence, but is a direct

108. Qwest Response to ATG 2-051S1, Confidential Attachment B; this is reproduced in Exhibit No.__(LLS-18C).

109. Grate (Qwest) Exhibit PEG 1-T at 17.

consequence of the PT&T/PNB/USWest local service franchise. The right to be the "official" publisher of the QC directories, along with the right to use the ILEC's name (as granted in the Branding Exhibit to the Publishing Agreement), the use of QC billing services, and QC marketing referrals are specifically valuable precisely because of QC's historical and continued position of dominance in the local exchange market. The long history of directory publishing as a virtual monopoly (prior to the 1999 FCC proceeding requiring ILECs to sell directory lists to competing publishers[110]) ensured that Qwest's Dex predecessors were able to develop substantial market share and competitive advantage that carries through to this day. An "official publisher" designation of a smaller, non-dominant local company would be less valuable.

Q. How should gain attributable to "franchise value" be allocated by this Commission?

A. The entire "franchise goodwill," resulting directly from QC assets, should remain where it currently resides, in QC. The value attributable to the transfer of the franchise value is likely to be substantial.[111] Without this commitment from QC, the Buyer would not have

110. *In the Matters of the Implementation of the Telecommunications Act of 1996: Telecommunications Carriers' Use of Customer Proprietary Network Information and Other Customer Information; Implementation of the Local Competition Provisions of the of the Telecommunications Act of 1996; Provision of Directory Listing Information under the Telecommunications Act of 1934, As Amended,* CC Docket Nos. 96-115, 96-98, 99-273, Third Report and Order in CC Docket No. 96-115, Second Order on Reconsideration of the Second Report and Order in CC Docket No. 96-98, and Notice of Proposed Rulemaking in CC Docket No. 99-279, Rel. September 9, 1999, 14 FCC Rcd 15550.

111. Qwest Response to ATG 01-013, Confidential Attachment A.

entered into the Purchase and other Agreements.[112] This is hardly surprising, when one considers what the Buyer would be purchasing *without* the ability to retain the existing Qwest directory market share. If QC were not being required by its parent to enter into the Publishing Agreement and Non-Competition Agreement with the Buyer, it would be able to accept bids and assign (with significant royalties) the Publishing Agreement and title of "official publisher" to an alternative directory publisher. All referrals of customer from QC for directory advertising would then be directed to the alternative directory publisher. Exhibit C to the Publishing Agreement would give that publisher the right to use the Qwest name and trademarks on its directories. Under those circumstances, it would be difficult, if not impossible, for the Buyer to maintain a market share anywhere near Qwest's current high level. The Buyer would, in effect, simply be another alternative directory publisher, a completely different company in the eyes of customers, than it is now.

Q. Has Qwest Dex itself generated any significant "goodwill" in terms of customer service or other customer satisfaction that would justify its market share apart from its relationship to the utility?

A. All indications show that Qwest Dex maintains its customers *in spite* of its customer service and customer relations. The evidence shows that Dex has run its operation as a monopoly with little attention to good vendor or customer relations. For example, National Management Services ("NMS"), a "Certified Marketing Representative" ("CMR") that sells yellow

112. *See* footnote 102, *supra.*

page advertising to national and regional yellow pages advertisers, filed an complaint against Qwest Dex claiming anti-trust violations.[113] NMS argues that Qwest, by virtue of its more than 80% Yellow Pages share, in some places as high as 100% share, has engaged in marketing and pricing methods designed to drive NMS from the market. According to the Complaint, in January of 2000, Dex established two separate price lists, forcing national and regional advertisers purchasing ads through CMRs to pay surcharges of between 6% and 20% over equivalent advertisements sold directly by Dex through its local sales force.[114] Dex's sales personnel then contacted NMS's customers, notifying them of the price difference between those available from local salesmen and those available to NMS. BEGIN QWEST HIGHLY CONFIDENTIAL<< [redacted]

[redacted] >>END QWEST HIGHLY CONFIDENTIAL

113. The complaint is currently under appeal in the 9th Circuit Court of Appeals (Docket No. 03-35109).

114. National Management Services, Inc. V. Qwest Dex, Inc, In the United States District Court, District of Oregon at Portland, Case No. CV 01-1772HU, December 7, 2001 This document is reproduced in my Exhibit No.__(LLS-19).

115. CMR Directory Advertising Agreement between NMS and US West Dex, Inc., dated March 1, 2000 (Included as Exhibit No. __ (LLS-20HC).

Documents provided in Qwest response to ATG 01-6 indicate that BEGIN QWEST HIGHLY CONFIDENTIAL<< BEGIN QWEST HIGHLY CONFIDENTIAL << [redacted]

116. See letters from CMRs to US West Dex, provided pursuant to Qwest response to ATG 01-011 included as Exhibit No. __ (LLS-21HC).

117. AM National Advertising Letter, included in Exhibit No. __ (LLS- 21HC).

118. Pelegrin Research Group, Inc., “Advertising Defector Tracking Study: Wave 4," July 2001, included in Exhibit No. __(LLS-22HC).

119. *Id.*, at 6.

[redacted] >>END QWEST HIGHLY CONFIDENTIAL

Q. Are there other assets being transferred from QC to the Buyer with substantial economic value stemming from QC's monopoly operations?

A. Yes. An additional contract between QC and the Buyer included in the Purchase Agreement is the Expanded Use List License Agreement,[121] BEGIN QWEST HIGHLY CONFIDENTIAL <<[redacted]

[redacted]

120. *Id.*, at 9.

121. Provided in Qwest Response to ATG 01-006 (Highly Confidential).

[redacted]

[redacted]>>END QWEST HIGHLY CONFIDENTIAL A Qwest-commissioned Lehman Brothers report estimated that the direct marketing business segment will generate incremental revenue of <<BEGIN QWEST CONFIDENTIAL [redacted] END QWEST CONFIDENTIAL>>[123] Dex's use of this list merely for its "database" business (where Dex provides database lists for direct marketers or fills in missing names, addresses and telephone numbers in client databases) currently produces <<BEGIN QWEST CONFIDENTIAL [redacted] END QWEST CONFIDENTIAL>>[124] in

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122. Qwest Response to WUTC 3-15.

123. Qwest Response to ATG DR 01-013, Confidential Attachment "A".

124. *Id.*

revenue, entirely attributable to the QC database rights. Full use of the rights granted in the Extended List License Agreement would create a value for the list significantly higher than this sum.

Only a small amount of the intangible value "goodwill" exists in the Dex operation itself.

Q. Are there any other sources of intangible value the Commission should consider?

A. Yes. There is a small amount of "goodwill" as described by Mr. Grate in his testimony. This "goodwill" consists mainly of the Dex workforce, which is being sold to the Buyer. The buyer would incur additional costs of hiring and training a new workforce if the Qwest Dex workforce were not included in the sale. Estimates of this cost would have reduced the purchase price.

Q. How should the Commission assign the goodwill associated with the Dex workforce in Washington?

A. The costs associated with ongoing maintenance of the Dex workforce were simply expensed on the Dex accounts. As a result, any additional costs increased the expenses of Dex, and therefore the amount imputed to ratepayers from the Dex sale. Under DCC, the gain attributable to this workforce should therefore be attributed to QC.

Q. Based upon your analysis of the QC assets included in this sale, how much of the gain on sale as represented by the Washington purchase price should flow to Washington Ratepayers?

A. As described above, Qwest is relying upon the historical and future association of Dex with QC for the vast majority of its sale price, yet proposing in the testimony of Mr. Grate and in the QC Contribution Agreement that QC should receive no portion of the sale price. Commission assurance that the full value of the intangibles owned by QC and previously included in the imputation from Dex to QC is the only way to ensure that Washington ratepayers can be made indifferent to the inclusion of the intangible QC assets in the Purchase Agreement.

Dex's provision of secondary directories and non-Qwest listings in primary directories, and all other such changes in Dex's directory publishing activities since 1984, do not qualify for exclusion from the directory publishing business for ratemaking treatment, so that the gains on sale attributable to those activities must not be treated any differently than the rest of Dex's directory publishing business.

Q. Separate from the issue of the allocation of the Dex sale transaction's proceeds between Qwest Corporation ratepayers and QCII that you have addressed earlier in your testimony, does Qwest accept that the entirety of the Dex directory publishing business should be subject to whatever QC/QCII allocation is ultimately adopted?

A. No. Qwest witnesses Theresa Jensen and George Burnett take the position that any and all improvements that have been made to Dex's directory publishing business since 1984 (the alleged date of transfer of the directory publishing business from USWC to US West Direct/Dex) can and should be considered separately from the state of the business at that time, and must be excluded from a calculation of the Qwest Corp. ratepayer's share of the gain on sale of the Dex business. As articulated by Ms. Jensen:

> Any ratepayer interest in the value of the directory publishing business is based on the Commission's recognition that, prior to 1984, publishing revenues and expenses were a part of Qwest's (the Company's) results of operations for regulatory purposes, which the Commission described as a "regulatory asset" of the Company. ... Identifying and removing that portion of the gain related to the business that was not part of Qwest's results of operation prior to the 1984 transfer leaves the remaining gain that is arguably subject to sharing between ratepayers and shareholders, recognizing the balance of interests required in this exercise.[125]

Q. What are the specific aspects of the directory publication business that Qwest proposes should be excluded from any calculation of the gain on sale assignable to Qwest Corp. ratepayers?

A. Qwest identifies two aspects of Dex's directory publication activities that it believes should be excluded from any calculation of the gain on sale assignable to ratepayers, namely the publication of so-called "secondary" directories and the publication of non-Qwest listings in Dex's "primary" directories.[126] Qwest defines its "primary" directories as the directories

125. Jensen (Qwest) Exhibit TAJ-1T, at 26-27 (as revised February 14, 2003).

126. Jensen (Qwest) Exhibit TAJ-1T, at 28-31. Qwest also proposes to exclude the portions of the sale transaction associated with the former long distance services company LCI, and the NewVentures/Internet lines of business that were formerly within the Marketing Resources (continued...)

that Dex publishes on its behalf due to regulatory obligations, and "secondary" directories as additional directories that Dex publishes at its discretion for competitive and strategic reasons.[127] In Washington, Dex currently publishes two directories that it classifies as "secondary," the Greater Snohomish County directory and the Greater Puget Sound On-the-Go directory.[128] The non-Qwest listings in its primary directories are mostly listings of other ILECs' telephone service subscribers, with about 10% being listings of CLEC customers.[129] Qwest is *obligated* by Secs. 251(b)(3) and 271(c)(2)(B)(viii) of the *Telecommunications Act of 1996* to provide such listings for CLEC customers.

Q. Does Qwest advance any legitimate reason to exclude these two aspects of the Dex directory business from the calculation of Dex sale proceeds that Qwest Corp. ratepayers are entitled to receive?

A. No. Qwest's position amounts to an attempt to take a snapshot of the Dex directory publication business at a single moment in time (in this case, the January 1, 1984 date of the alleged transfer of the directory publishing function from Pacific Northwest Bell and the other regulated operating companies that merged to become USWC, to Dex's predecessor,

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126. (...continued)
Company (MRC) subsidiary. Jensen (Qwest) Exhibit TAJ-1T, at 27 (revised 2/14/03) and 28.

127. Jensen (Qwest) Exhibit TAJ-1T, at 28-30.

128. *Id.*, at 29.

129. *Id.,* at 30 (revised 2/14/03).

US West Direct),[130] and to limit the Commission's consideration of the business to only those operations that were occurring then, i.e., over nine years ago. Of course, like any ongoing business, the Dex operation has changed over time in many respects, including but not limited to changes in its directory advertising subscribership, advertising rates, number and scope of directories, directory circulation, and numerous other factors. Some of these factors also undoubtedly changed over the years prior to 1984, when the directory publication function was undertaken directly by Qwest Corp.'s predecessor, Pacific Northwest Bell. That being said, Qwest has not advanced any sound economic rationale for concluding that a subset of those changes, namely the introduction of secondary directories and inclusion of non-Qwest primary listings after 1984, should qualify for different treatment in the context of the sale of the Dex business than any other changes in the business over time. Put another way, *Dex has provided no basis for believing that, had the directory publishing activity remained within the QC entity throughout this period, the publication of "secondary directories" would not itself have been undertaken by the QC directory publishing operation rather than by the affiliate*.

Q. Is Qwest's proposal to exclude secondary directories and non-Qwest primary listings supported by distinctions in how those activities are financed or conducted by Dex?

A. No. Dex's publication of secondary directories and non-Qwest primary listings are financed from the same sources as the rest of Dex's business operations, with no separate lines of

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130. *See generally*, *Yellow Pages Imputation Accounting Order,* at paras. 8-12.

credit or other external funding targeted to those two activities. BEGIN QWEST HIGHLY CONFIDENTIAL<< [redacted] >>END QWEST HIGHLY CONFIDENTIAL Mr. Burnett contends that Dex's directory operations are all "self supporting" and "require no large capital infusions from the parent corporation," and does not identify any special financing arrangements made for the two activities that Qwest is attempting to carve out from Dex's overall business.[132] BEGIN QWEST CONFIDENTIAL<< [redacted] >>END QWEST CONFIDENTIAL Indeed, in addressing how Subscriber List Information ("SLI") is handled, Ms. Jensen admits that "QC integrates the subscriber lists of other providers into its SLI and transmits that information to Dex. Other providers' SLI is not differentiated from its own in any way." [134] Given that the integration of non-Qwest listings

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131. See Loan Agreement Governing Borrowings From Qwest Capital Funding, Inc. to Qwest Dex Holdings, Inc., January 15, 2001. This document was provided in response to ATG 01-006 (Highly Confidential).

132. Burnett (Qwest) Exhibit GAB-1T, at 8.

133. See, e.g., ATG 01-013, Confidential Attachment A ("Descriptive Memorandum"), at 13-24.

134. Jensen (Qwest) Exhibit TAJ-1T, at 13. Jensen testifies that QC will continue to integrate other providers' SLI after the sale. *Id.* at 13.

is done in this fashion precisely in order to meet Qwest's regulatory obligations as an ILEC, as Ms. Jensen acknowledges (pages 9-11, and 30-31), Qwest's unabashed attempt to portray Dex's publication of non-Qwest listings as an entirely separate, incidental publishing activity is disingenuous and fatally flawed.

Q. But Qwest also points to its inclusion of other ILECs' subscriber listings and claims that, because doing so is discretionary, the value that those listings add to its directories should not be made available to ratepayers when determining how to allocate the gain on the Dex sale transaction. Do you agree with that position?

A. No. Dex clearly has wide discretion in determining how it should design and produce the directories that it publishes, including those published in order to meet Qwest's regulatory obligations concerning directories. That discretion allows Dex to follow its best business judgments as to how to best maximize the utility and value of its directories, from relatively narrow design decisions such as the appearance of the directory cover, inclusion of informational pages, and typefaces, to more strategic decisions such as to include other ILECs' subscriber listings or to introduce "secondary" directories. However, all of those decisions are made within the context of operating a directory publication business that the Commission has determined was historically a "regulatory asset" and remains so today, despite the 1984 consolidation of the directory publishing function into Dex.

To the extent that Dex has improved upon the directory publishing operations as they existed in 1984, e.g. by adding other ILECs' listings or introducing new (secondary) directories, those changes are entirely consistent with Dex's obligations as QC's outsourcing contractor with respect to the publication of QC directories. Indeed, Dex uses the very same brand identification and marks on its "secondary" directories as it applies to its "primary" books, and capitalizes upon customer and advertiser familiarity with the primary directories in launching and marketing these additional publications.[135] Moreover, the very same sales and support organizations are involved in both the primary and secondary directory publishing activities. Dex gains considerable competitive and operational advantage in the secondary directory business from its continued and continuing publication of QC primary directories, and would not possess such advantages if it were not also publishing the primary directories as an outsource contractor for QC.

With respect to the inclusion of CLEC and other ILEC listings in the QC directories, Qwest's attempt to quantify the incremental value of its addition of other ILECs' subscriber listings is flawed, because it has not demonstrated that those listings add value in the same proportion as the other listings in Dex's directories. Consequently, the contention that certain incremental value to the Dex directory business can be ascribed to Dex's "discretionary" decisions and thereby removed from regulatory consideration is invalid and should be rejected by the Commission. Moreover, even if inclusion of those listings does add incremental value, that increment also inures to QC and not to Dex, since it would not exist if Dex were not publishing the QC directories as QC's outsource contractor.

135. As I cited earlier in my testimony (page 89), BEGIN QWEST CONFIDENTIAL << [redacted] >> END QWEST CONFIDENTIAL

Q. Qwest also proposes to exclude the value of Dex's NewVentures/Internet operations from any attribution to ratepayers. Has Qwest justified that exclusion?

A. No. Ms. Jensen contends that Dex's NewVentures/Internet operations were historically separate from the directory publishing business, and should not be subject to any allocation to ratepayers.[136] On that basis, Ms. Jensen excludes Qwest's claimed value for those operations from its proposed calculation of sale gains allocable to ratepayers.[137] However, Qwest's year 2000 affiliated interest report to the Commission states the following:

BEGIN QWEST CONFIDENTIAL << [redacted]

[redacted]

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136. Jensen (Qwest) Exhibit TAJ-1T, at 28.

137. Jensen (Qwest) Exhibit TAJ-2C.

138. Qwest Response to ATG 01-013, Confidential Attachment A, at 8.

[redacted]>>END QWEST CONFIDENTIAL

Q. Has the Commission ever limited its imputations of revenues from the directory publishing business to exclude particular lines of business or revenues associated with specific business augmentations?

A. No. Despite Ms. Jensen's suggestion to the contrary,[139] the Commission's prior imputations of directory revenues have never recognized less than the entirety of the directory business. In fact, in each of the last three occasions on which a specific directory revenues imputation has been made, the Commission has calculated the imputation based on Dex's total annual revenues, net of expenses, generated by all of its various operations and lines of business, without distinction.[140] As the Commission has concluded repeatedly in the course of the

139. Jensen (Qwest) Exhibit TAJ-1T, at 27 (revised February 14, 2003). Therein, Ms. Jensen quotes the *Yellow Pages Imputation Accounting Order* as stating that imputation "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."

140. See, e.g., Qwest Response to ATG 05-81, Confidential Attachment A, tab 1, for the calculation methodology. As shown therein, Line 1 is US West Direct (Dex) Gross Revenues.
(continued...)

Company's persistent attempts to divert the revenue stream from directory advertising out from its regulated operations,

> The public interest requires that the full reasonable value of the directory publishing enterprise be deemed available to PNB for ratemaking purposes.[141]

Today, the "full reasonable value of the directory publishing enterprise" would necessarily include all aspects of Dex's current operations, which are summarized by Mr. Burnett as encompassing:

> Dex publishes directories which contain white and yellow pages listings, sells advertising in its primary, secondary, and specialty directories, creates and sells other information, distributes directories for QC and others, and furnishes Internet, electronic, and talking Yellow Pages. In addition, Dex's white pages listings are more than simple directories, including informational supplements, enhanced listings, and certain advertising.[142]

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140. (...continued)
The imputation subtracts operating expenses and allocated administrative overheads to develop a net operating income (NOI) figure. Thereafter, all NOI, in excess of an amount equal to the US West Direct (Dex) investment base times the USWC (Qwest) authorized rate of return, is imputed to the regulated Company. The "portion" referred to in the Commission order cited by Ms. Jensen presumably refers to this latter calculation, and clearly does not refer to excluding any particular Dex lines of business from the imputation.

141. WUTC Docket U-86-156, Second Supplemental Order, October 11, 1988, at 10. See also WUTC Docket UT-950200, Fifteenth Supplemental Order, April 11, 1996, at 21**, which states (at Note 20): "The Company argues that this order did not become final for procedural reasons involving the settlement of litigation. Whether or not we treat the order as "precedential," we believe that it expresses a sound analysis and we accept and adopt the analysis as having continuing validity."

142. Burnett (Qwest) Exhibit GAB-1T, at 6.

In summary, contrary to Qwest's testimony, there is no legitimate economic or financial basis to consider improvements in Dex's directory operations since 1984, such as the provision of secondary directories and non-Qwest listings in primary listings, as separate from the directory publishing function that is treated as a regulatory asset, and all of the gains on sale attributable to those activities should be treated no differently from the rest of the Dex business.

Q. Do you agree with the allocator that Qwest proposes to use to determine the Washington portion of the sale transaction value?

A. No, I do not. In the Preliminary Gain on Sale calculation presented by Ms. Jensen, Qwest applies a revenues-based allocator of BEGIN QWEST CONFIDENTIAL << [redacted] >> END QWEST CONFIDENTIAL. This allocator reflects only Washington's share of Qwest's primary directory-derived revenues (based on year 2001 data), and excludes revenues derived from secondary directories, non-Qwest primary listings, and Dex's NewVentures/Internet operations. As I explained earlier in my testimony, none of those three activities should be excluded from a calculation of gains attributable to ratepayers. Moreover, even though I recognize that the Commission has used revenues-based allocators in the past in order to determine Dex earnings imputations, a true earnings-based allocator is clearly more accurate for the purposes of determining how the Washington state operations contribute to the overall value of the Dex business, since a revenues-based measure would fail to reflect differences in expenses that also impact relative earnings. Accordingly, using Dex's detailed revenue and expense data for year 2001 generated by Dex's Product

Profitability Reporting system,[143] I have calculated an earnings-based allocator that expresses the earnings of the Washington operations as a percentage of the earnings generated by Dex's overall operations. The resulting allocator is BEGIN QWEST CONFIDENTIAL << [redacted] >> END QWEST CONFIDENTIAL, and I recommend that the Commission use this figure for purposes of determining the Washington portion of Dex's overall value.[144]

143. Provided in Qwest Response to ATG 01-006.

144. See my Confidential Exhibit No.__(LLS-24C), at page 2.

RECOMMENDATION

Q. Dr. Selwyn, what are your overall recommendations to the Commission with respect to its disposition of Qwest's application for approval of the proposed Dex sale?

A. My principal recommendations to the Commission relative to Qwest's proposed sale transaction for the directory publishing business are as follows:

- The Commission should find that Qwest's proposed sale of the Washington portion of the Dex directory business is not in the public interest and that it will harm Washington ratepayers as well as financially weaken QC's ability to provide safe and reliable local exchange telephone service in Washington, and on that basis should not approve the sale transaction as presently structured..

- If the Commission nevertheless determines that Qwest should be permitted to proceed with the sale transaction, it should do so if and only if Qwest accepts and implements certain modifications to the Company's proposal for conferring an appropriate share of the gains on the sale to Washington ratepayers so as to minimally satisfy the "ratepayer indifference" public interest standard. As set forth in my testimony, those modifications are as follows:

    - The calculation of the gain on sale should be based upon an imputed fair market value for the directory publishing business as a whole of BEGIN QWEST

CONFIDENTIAL << [redacted] >> END QWEST CONFIDENTIAL, depending upon the use of an earnings- or a revenue-based allocator for the Washington share, respectively, rather than the $7.05-billion distress price that the Buyer has agreed to pay.

- The value of Dex's Secondary Directories, Non-Qwest Primary Listings, and NewVentures/Internet operations should not be excluded from the calculation of the aggregate gain to be flowed through to QC's Washington ratepayers;

- Instead of Qwest's proposal to limit the Washington ratepayer share to 50% of that portion of the Pre-Tax Gain that Qwest ascribes to Dex's primary directory business (to be accomplished via a continuation of imputations for only five years), the Commission should find that Washington ratepayers are entitled to 100% of the Washington share (as determined based upon Dex earnings) of the entire Dex operation, to be flowed through to ratepayers via the methodology described forth by Dr. Blackmon.

Were each of these modifications implemented by Qwest, then the Dex sale transaction would at least minimally satisfy the "ratepayer indifference" public interest standard, so that Commission approval of the transaction would then not harm Washington ratepayers.

Q. Does this conclude your direct testimony at this time?

A. Yes, it does.