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- QWEST CORPORATION'S APPLICATION REGARDING TRANSFER AND SALE OF DIRECTORY BUSINESS AND NOTICE OF POSSIBLE AFFILIATED INTEREST TRANSACTION

Qwest Corporation ("QC"), by and through its undersigned counsel, and on behalf of its affiliates, Qwest Dex, Inc., Qwest Services Corporation ("QSC") and Qwest Communications International, Inc. ("QCI"), hereby submits this application and notice pursuant to Chapters 80.12 RCW, 480-143 WAC and, if applicable, 80.16 RCW and 480-146 WAC. This application and notice regards the permanent transfer and sale (the "Dex sale") of the Qwest Dex directory publishing business and associated assets (the "directory business") to Dex Holdings, LLC (the "Buyer").

I. RELIEF REQUESTED

Qwest respectfully requests the Commission enter an order:

A. Confirming that the Commission does not have jurisdiction over the sale of the directory business to the Buyer.

B. Alternatively, if the Commission finds that it has jurisdiction over the sale, approving the sale pursuant to Chapters 80.12 RCW and 480-143 WAC.

C. Addressing the financial consequences of the Dex sale.

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II. DESCRIPTION OF THE TRANSACTING PARTIES AND THE TRANSACTION

A. The Seller

The assets that comprise the directory business are held on the books of Qwest Dex, Inc., a wholly-owned subsidiary of Qwest Dex Holdings, Inc. QSC, a wholly-owned subsidiary of QC's ultimate corporate parent, QCI, is the parent of both QC and Qwest Dex Holdings, Inc. Attached as Exhibit A is a chart depicting Qwest's corporate structure as of June 2002. Qwest Dex, Inc. is the named seller under the Dex sale purchase agreements. QSC and QCI are also parties to the Dex sale purchase agreements. Pursuant to WAC 480-143-120, attached as Exhibit B are current financial statements of QC.

B. The Buyer

The Buyer is Dex Holdings, LLC, a Delaware limited liability company newly formed by Carlyle Group ("Carlyle") and Welsh, Carson, Anderson & Stowe ("WCAS") to purchase the Dex publishing business. Buyer has agreed to purchase and operate the entire Dex publishing business for $7.05 billion, subject to adjustment for working capital and final audited Dexter and Rodney financial statements. The Buyer has significant capital – combined, Carlyle and WCAS have over $25 billion of committed capital under management.

Each of Carlyle and WCAS brings to the table a history of operating communications-related businesses and extraordinary leadership, both in management generally but also in communications-related business specifically. As just a few examples, WCAS' portfolio companies include Centennial Communications (a provider of rural wireless services), Valor Telecommunications (a rural wireline provider), and Amdocs (a provider of OSS and billing software to the communications industry). Carlyle is widely known and respected not only for the strength of its managers and directors with communications experience such as former Federal Commission Chairman William Kennard, former Verizon Executive Vice President for Strategy James Attwood and other former senior executives from various telecommunications companies, but also for its exceptional senior leaders – e.g. former Secretary of State, Secretary of the Treasury and White House Chief of Staff James A. Baker III, and former Securities and Exchange Commission Chairman Arthur Levitt. Carlyle also has communications

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ownership experience that includes Pacific Telecom (submarine fiber optic cable), Neptune Communications (high-speed networks), CityNet (metro-area broadband infrastructure) and Genesis Cable (a U.S. cable television operator). *See Iowa Utilities Board, Docket No. SPU 02-15, Response of Investors The Carlyle Group and Welsh, Carson, Anderson & Stowe (August 28, 2002), at 1-3.*

C. The Transaction

The Dex sale is comprised of two principal purchase agreements executed on August 19, 2002 – the so-called Rodney agreement and the so-called Dexter agreement – and numerous ancillary agreements attached as exhibits to the two purchase agreements. Pursuant to WAC 480-143-120, copies of the purchase agreements are attached hereto as Non-Confidential Exhibits C (Rodney) and D (Dexter). QC is still in the process of reviewing the ancillary agreements in order to ensure that the parties' confidential information is properly protected. QC anticipates filing the ancillary agreements in the near future following entry of an appropriate protective order. An overview of the transaction follows.

- Assets. This transaction involves the sale of the entire business of Qwest Dex, Inc. ("Dex") in two stages which will close at different times, referred to respectively as "Dexter" and "Rodney." The first (Dexter) stage includes the Dex operations in Colorado, Iowa, Minnesota, Nebraska, New Mexico, North Dakota and South Dakota (the "Dexter Region"). The second (Rodney) stage includes the Dex operations in Arizona, Idaho, Montana, Oregon, Utah, Washington and Wyoming (the "Rodney Region").

- Purchase Price. $7.05 billion, subject to adjustment for working capital and final audited Dexter and Rodney financial statements. The purchase price is allocated $2.75 billion to Dexter and $4.3 billion to Rodney.

- Closing Dates. It is anticipated that Dexter will close in 2002 (the "first closing") and that Rodney will close six to twelve months after signing, depending upon how quickly state approvals (if required) are received (the "second closing"). The deadline for the first closing is December 15, 2002 and for the second closing is December 15, 2003.

- Closing Conditions. The consummation of the first closing and the second closing are conditioned, among other things, on (a) the receipt of debt financing on the terms set forth in Buyer's commitment letters, (b) the separation of the Dexter and Rodney businesses being consummated and (c) the termination or expiration of the applicable waiting period under the Hart-Scott-Rodino Act. The second closing may not occur in the event that state commissions, individually or collectively, order gain-sharing, rate reductions, additional capital investments or other forms of economic loss to QCI and/or its subsidiaries (including QC) in excess of a specified level.

- Mechanics of Closing. Just prior to the first closing, Qwest Dex, Inc. will transfer the Dexter assets and liabilities to its newly-created subsidiary, SGN LLC. At the first closing, the ownership of SGN LLC will transfer from Qwest Dex, Inc. to the Buyer. A similar course of

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events will occur just prior to and at the second closing for the Rodney sale through GPP LCC, a separate newly-created subsidiary of Qwest Dex, Inc.

- <u>Other Operational Transaction Agreements</u>. In addition to the purchase agreements governing the Dexter and Rodney transactions, agreements have been reached for the following commercial arrangements in connection with the transaction:

  ◊ Transition and Separation Arrangements.

    ♦ *Separation Agreement*. Rodney and Dexter will utilize shared assets, systems and facilities following the first closing in order to more efficiently and cost effectively operate the business prior to the second closing. This agreement establishes the key covenants and obligations necessary to share these resources and protect the parties' confidential information while maintaining operational integrity of the two companies. This agreement also sets forth the parties' respective responsibilities to separate the jointly maintained data, systems and processes and eliminate the dependence on transition services provided by the parties to each other if the Rodney closing fails, so that Dexter and Rodney will operate as completely independent companies.

    ♦ *Transition Services Agreement*. QCI and its subsidiaries will provide back-office and other support services to Dexter following the first closing for a period of up to 18 months.

    ♦ *Professional Services Agreement.* Dexter will provide necessary centralized services that Rodney will require following the first closing as a result of the transfer of certain personnel to Dexter at the first closing.

    ♦ *Joint Management Agreement*. Rodney and Dexter will each employ key senior management team executives during the transition period. The senior management team will run both companies consistent with applicable fiduciary duties and responsibilities. Conflicts of interest will be resolved by a liaison committee, if possible.

  ◊ *Publishing Agreement.* QC has entered into a publishing agreement designating the Buyer as QC's exclusive official publisher in the Region. In connection with the Publishing Agreement, QC and Buyer will enter into the following ancillary agreements:

    ♦ *Directory License Agreement.* QC will grant to the Buyer for the term of the Publishing Agreement a restricted license to use the directory publisher lists and directory delivery lists for the sole purpose of publishing and delivering the directories in the 14-state region.

    ♦ *Non-Directory License Agreement.* QC will grant to the Buyer a restricted license to use the subscriber list information in its direct marketing activities for a term of five years.

    ♦ *Public Pay Stations Agreement.* The Buyer will place directories in all of QC's public pay stations in the Region available for directory placement (with certain limited exceptions) for the term of the Publishing Agreement.

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◊ *IP Contribution Agreement*. The assignment or licensing of QCI's and Qwest Dex, Inc.'s intellectual property used in the directory business to the Buyer is effected by the IP Contribution Agreement.

◊ *Trademark License Agreement*. The agreement grants Buyer a license to use the "Qwest Dex" trademark for a period of five years to sell directory products and direct marketing products primarily targeted at end users within the Region.

III. DISCUSSION

A. The Commission Should Confirm that it Lacks Jurisdiction to Approve the Sale of the Directory Business.

1. The history of Dex in Washington.

QC's and U S WEST Communications, Inc.'s ("U S WEST") predecessor, Pacific Northwest Bell ("PNB"), published directories for PNB's exchanges in Washington. Before divestiture in 1984, PNB's regulated accounts included both the expenses and the revenues associated with its directory business operations. The tangible asset investment used to publish the directories was included in PNB's regulated rate base. However, PNB's regulated rate base did not include any amount for the intangible assets of going concern value of the directory business, the right to publish directories for the telephone company or any other form of unrealized goodwill (collectively hereinafter, "goodwill"). Further, no return on the intangible investment in these goodwill type assets or return of that investment in depreciation charges was allowed under regulation of PNB in Washington.[1]

Incident to the divestiture of the Bell System, PNB transferred its directory publishing operations, including employees, tangible assets and working capital, to its unregulated affiliate, Landmark Publishing Company ("Landmark").[2] In December 1983, PNB applied for approval of the transfers of the tangible assets, a leasehold interest, cash working capital and of publishing agreements between Landmark and

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1 The Commission has historically disallowed, for ratemaking purposes, expenses for image advertising which was designed to create and enhance the company's goodwill. Accordingly, QC and its predecessors did not receive support from ratepayers for expenses incurred in efforts to create and enhance its goodwill through image advertising. Instead, the company's stockholders bore the costs of such image advertising.

2 Since the end of 1983, the directory business has been operated by a subsidiary of Landmark, initially named U S WEST Direct and now called Qwest Dex, Inc. The directory business Qwest Dex, Inc. operates today is different in several significant ways from the business which had previously been operated by PNB. For example, the directory business has expanded into geographical areas where QC does not provide regulated telecommunications local exchange service. Also, Qwest Dex includes CLEC listings and sells advertising to CLEC-served businesses. The directory business has also expanded into new markets, such as the Internet, which do not involve regulated local exchange telecommunications service.

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PNB. The Commission, while not approving the compensation associated with the transfers or publishing agreements for ratemaking purposes, approved the transfers and publishing agreements pursuant to Chapters 80.12 and 80.16 RCW. 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 PNB's operations for ratemaking purposes. *In re PNB Tel. Co., Cause No. FR-83-159, Order Granting Application, in Part, (December 30, 1983), at 2; Docket No. UT-980948, Fourteenth Supplemental Order (the "Accounting Order"), ¶ 27.*

In Docket No. UT-950200, U S WEST challenged the Commission's authority to impute directory earnings to U S WEST's regulated operations. The Commission rejected this challenge and ordered imputation of directory earnings in an amount equal to what would have been shown on U S WEST's regulated accounts if the 1983 transfer had not occurred. The Commission ordered this as compensation for PNB's transfer of the "valuable regulatory asset" of the directory publishing business for inadequate consideration. The Commission imputed directory revenue of $80 million annually (equivalent to approximately $51 million net income) into U S WEST's regulated accounts in the rate case. *WUTC v. U S WEST Communications, Inc., Docket No. UT-950200, Fifteenth Supplemental Order*.[3]

On appeal, the Washington Supreme Court upheld the Commission's decision in Docket No. UT-950200, but held that imputation of directory earnings could end when there was a sale of the business and fair compensation had been received by U S WEST. *U S WEST Communications, Inc. v. Utilities and Transportation Commission, 134 Wn.2d 48, 102, 949 P.2d 1337 (1997).*

Following the Supreme Court decision, U S WEST filed a request to end imputation in Docket No. UT-980948. U S WEST introduced evidence of the value of the directory business as it had existed in 1983 and evidence that the cumulative publishing fees received by PNB and imputed directory earnings included in rates of PNB and U S WEST since divestiture exceeded that value plus reasonable interest

[3] In addition, in Docket No. UT-970766, the Company's rates were adjusted based on updated earnings information. This case did not change the mechanism of imputation, but increased the annual revenue imputation from $80 million to $85 million (equivalent to $54 million in annual directory earnings imputation).

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since 1983. The Commission denied U S WEST's request, holding that the directory publishing "function" had never been permanently transferred to Landmark from PNB in 1983 or at any subsequent time by it or any successor company. The Commission held that it had only been asked in 1983 and later cases to approve certain publishing agreements and transfers of certain tangible assets and cash. *Accounting Order, ¶¶ 169, 176, 177.*

2. The Dex sale does not require Commission approval.

Goodwill. QC does not believe the Dex sale is subject to Chapters 80.12 RCW and 480-143 WAC. RCW 80.12.020 requires pre-approval of any sale, lease, assignment or other disposal by a public service company of any of its franchises, properties or facilities <u>which are necessary or useful in the performance of its duties to the public</u>. The Commission's rules clarify that, for purposes of RCW 80.12.020, property is not "necessary or useful" if it is excluded from the public service company's rate base. *WAC 480-143-180(4).*

QC does not suggest that this lack of authority changes the Commission's rulings in the prior dockets associated with directory revenues and/or earnings and the imputation of those revenues for ratemaking purposes. The Accounting Order includes an extensive discussion characterizing the transfers that occurred pursuant to PNB's request in Docket No. FR-83-159 and subsequent proceedings and the Commission approval obtained in each. The Accounting Order repeatedly states that PNB had transferred certain assets, but only temporarily outsourced the publishing function. *Id., at ¶¶ 141, 147, 155, 158, 159, 176.* This statement, combined with the many references in the Accounting Order that PNB had not permanently transferred the "entire" business or the "publishing function" (*see, id., Synopsis, ¶¶ 19, 141, 153, 154*), suggests that the Commission held that the tangible and certain intangible directory assets were permanently transferred to PNB's unregulated affiliate (now Qwest Dex, Inc.), but not all rights to the asset had been addressed by the Commission. *Id., at ¶ 169.*

Based on this understanding, QC interprets the Accounting Order to hold that the goodwill associated with the directory business is still retained by QC.[4] Assuming this is the case, under

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[4] While QC disagrees with the Accounting Order in this respect and seeks to preserve its right to disagree with such a finding, for purposes of this application and notice, QC will assume that QC still holds the goodwill associated

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Washington law, no approval is required for the sale or transfer of this asset to a non-affiliate.

The goodwill associated with the directory business in Washington has always been excluded from the rate base of PNB, U S WEST and QC. In fact, there is no asset of any kind on QC's Washington regulated asset accounts which pertains to the directory business. As such, the transfer of goodwill to the Buyer does not require approval, even if the transferor is QC.

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

B. <u>Alternatively, the Commission Should Expeditiously Approve the Sale</u>.

In the event the Commission finds that it has jurisdiction to review and approve the Dex sale, QC respectfully requests the Commission to promptly approve the sale as being consistent with the public interest for a number of reasons.

First, the Dex sale will improve QCI's and QC's collective financial health. QCI is the equity market interface for QC. QCI expects to use the proceeds of the Dex sale to pay down debt and to meet other funding requirements. QCI has embarked on an effort to significantly reduce its substantial debt burden. The Dex sale is an element of that strategy, which is intended to allow QCI to de-lever its balance sheet. QCI must restructure its debt in order to avoid a failure to comply with financial covenants contained in the terms of that debt. Compliance with those financial covenants is currently in jeopardy. It is very likely that QC would not be insulated from the adverse consequences of a failure by QCI to meet its financial covenants, should that occur.

Second, the Commission should understand that while the directory business is a vibrant enterprise, it is not critical to Qwest's core business, the provision of local (and soon, upon FCC approval, inter-LATA long distance) telephone service to residential and business customers in its 14-state region.

Third, the investment in the directory business being made by the Buyer ensures that Washington

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with the Washington operations of the directory business.

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residents will continue for many years to have access to the Dex directories, both as consumers and as advertisers.

Finally, the Dex sale agreements require the Buyer to publish and distribute white pages directories in QC's exchanges and to perform the obligations imposed on QC by its interconnection agreements to include in those directories the listings of end user customers of CLECs. Thus, the deal's structure assures that Washington ratepayers will not be harmed by this sale.

C. The Commission Should Address the Financial Consequences of the Dex Sale.

In the Accounting Order, the Commission recognized that future events might require a reexamination of certain aspects of the financial relationship between QC and Dex. *Accounting Order,* ¶¶ *175, 179, 180.* Certain provisions of the Rodney purchase agreement require QCI to quantify any regulatory impacts associated with the transaction. *See, e.g., Exhibit C, at § 5.4(b)(ii).* Indeed, given QCI's purposes for consummating the Dex sale, the Rodney sale may not close if the associated regulatory impacts exceed the threshold set forth in the purchase agreement. Thus, the Commission should address the financial consequences of the Dex sale.

IV. NOTICE OF POTENTIAL AFFILIATED INTEREST TRANSACTIONS

RCW 80.16.020 requires QC to file a copy or summary of any contract or arrangement for the furnishing, purchase, sale, lease or exchange of any property, right or thing between itself and an affiliated interest. Out of an abundance of caution, QC hereby notifies the Commission that aspects of the Dex sale agreements may be deemed by the Commission to trigger Chapters 80.16 RCW and 480-146 WAC. These include the following.

Pass-through transfer to GPP LLC. As noted in section II.C. above, the structure of the Dex sale will require the transfer of the Rodney assets from Qwest Dex, Inc. to its newly-created affiliate, GPP LLC, immediately prior to closing. At closing, the ownership of GPP LLC will be transferred from Qwest Dex, Inc. to the Buyer. In substance, this is a sale or transfer to an unaffiliated entity, the Buyer, which uses an affiliate as a conduit for a very brief period of time. In substance, this is not an affiliated interest transaction between QC and GPP LLC.

To the extent that the Commission finds the Dex sale is resulting in a transfer of a QC asset, QC

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would anticipate that the Commission may also therefore find the Dex sale to involve an affiliated interest transaction since that asset is, albeit only for an instant, arguably moving from QC to another of QC's affiliates (GPP LLC).

While, as discussed above, QC does not believe any QC asset is being transferred in the Dex sale and that this notice is not required, QC is sensitive to the Commission's possible disagreement and wants to make sure that it fully complies with its statutory and regulatory notice obligations.

Publishing and related agreements. The statutory definition of "affiliated interest" includes every corporation or person with which the public service company has a management or service contract. *RCW 80.16.010*. The meaning and breadth of "management or service contract" are unclear on the face of the statute. As described in section II.C. above, the Dex sale agreements include a Publishing Agreement and a Public Pay Station Agreement, both of which, depending on the scope of "management or service contract" in RCW 80.16.010, may arguably give rise to the notice requirements under RCW 80.16.020.

To the extent the Commission believes that the mechanics of the transfer or other terms of the purchase or ancillary agreements trigger filing obligations under Chapters 80.16 RCW and 480-146 WAC, this notice is offered by QC. QC submits that, for the reasons discussed above, the Dex sale is reasonable and consistent with the public interest.

V. CONCLUSION

For the foregoing reasons, Qwest respectfully requests that the Commission expeditiously consider this application and grant the relief specified in section I. above.

RESPECTFULLY SUBMITTED this _____ day of August, 2002.

QWEST CORPORATION

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CERTIFICATION PURSUANT TO WAC 480-143-140

I, YASH RANA, Secretary of Qwest Corporation, hereby certify that the information contained in this Application and Notice is true and correct to the best of my knowledge and belief under penalty of perjury under the laws of the State of Washington. Signed at Denver, Colorado this _____ day of August, 2002.

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Yash Rana, Secretary
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