BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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

REBUTTAL TESTIMONY OF

JOSEPH P. KALT

ON BEHALF OF

DEX HOLDINGS LLC

APRIL 17, 2003

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I. INTRODUCTION AND BACKGROUND

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Joseph P. Kalt. I am the Ford Foundation Professor of International Political Economy at the John F. Kennedy School of Government, Harvard University, Cambridge, Massachusetts. I am also a Senior Economist at Lexecon, Inc., an economics and public policy consulting firm with offices in Cambridge, Massachusetts, and Chicago, Illinois. My business address at Lexecon is One Mifflin Place, Cambridge, Massachusetts 02138.

Q. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND.

A. I received my B.A. degree in economics from Stanford University in 1973, and my M.A. (1977) and Ph.D. (1980) degrees in economics from UCLA. I am a specialist in the economics of competition, regulation, and antitrust, with particular emphasis on the energy, transportation, and financial industries. Throughout my professional career, I have conducted research, published, taught, and testified extensively on the economics of market structure, contracting, regulation, pricing, and strategic performance. I have previously testified in state and federal courts and before numerous regulatory boards and commissions (including the Federal Communications Commission) on matters concerning competition and regulation.

Q. PLEASE SUMMARIZE YOUR PROFESSIONAL WORK EXPERIENCE.

A. Prior to joining the faculty at Harvard in 1978, I served on the staff of the President's Council of Economic Advisers (1974-1975), with responsibility for economic analysis of regulated industries. At Harvard, I served as an Instructor, Assistant Professor, and Associate Professor in the Department of Economics (1978-1986) prior to joining the faculty of the Kennedy School of Government as a Professor with tenure in 1986. I have had responsibility for teaching graduate and undergraduate courses in antitrust economics, regulation, and public policy.

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In addition to serving as a Professor at the Kennedy School, I have served as Chair of the Economics and Quantitative Methods Cluster, Faculty Chair and Academic Dean for Research, Chair of Teaching Programs, and Chair of Ph.D. Programs. I am the Faculty Chair of the Harvard University Native American Program. A copy of my current curriculum vitae is attached to this report as Exhibit ___ (JPK-2).

II. SCOPE OF TESTIMONY AND SUMMARY OF CONCLUSIONS

Q. WHAT ISSUES DOES YOUR TESTIMONY HERE ADDRESS?

A. I have been asked by counsel for Dex Holdings, LLC ("Dex"), to examine the economic and public policy issues arising from Qwest Communications International, Inc.'s ("QCI"), proposed sale of Qwest Dex, its telephone directory business, to Dex. My testimony provides an analysis of the economic benefits arising from the proposed sale of Qwest Dex to Dex, and I address the principles underlying Qwest Corporation's ("QC") proposal for sharing the gain on the sale with ratepayers. I have also examined the circumstances surrounding the sale of Qwest Dex to assess claims that the business was sold at a price below its full fair market value.

Q. PLEASE SUMMARIZE YOUR CONCLUSIONS ON THESE POINTS.

A. The public as a whole has an abiding interest in the sound functioning and regulation of the markets for local exchange services, and secondarily, of the markets for advertising. Thus, where there is a policy of moving toward the use of competitive forces to determine what services will be offered and to discipline the prices of local exchange services, as in the state of Washington,[1] the public's interest will not be served in the long term by a policy that distorts the price paid for regulated services obtained from the Incumbent Local Exchange Carrier ("ILEC") so as to bias the competitive process

[1] ***See, e.g.,*** RCW 80.36.300; *Washington Utilities and Transportation Commission ("WUTC") –v- U.S. West Communications, Inc.*, WUTC Docket No. UT-950200, Fifteenth Supplemental Order, Commission Decision and Order Rejecting Tariff Revisions; Requiring Refiling, at 9.

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between the ILEC and others. Where regulation seeks to promote competition for the benefit of all ratepayers, conceptions of the public's interest that solely turn on rates paid by remaining customers of the regulated ILEC are too narrow and fail to account for numerous factors in which the public has legitimate interests.[2]

Recommendations for either blocking the sale of Qwest Dex or constraining the sale by perpetual imputation of sale proceeds into the ILEC's rates imply sustained un-leveling of the competitive playing field and attendant adverse impacts on the public's interest in a competitive and dynamic telecommunications marketplace. Any continued imputation that reduces the regulated price of services and distorts competition in those services should be limited in time and established at the level necessary to effect reasonable sharing of the gain on the sale of Qwest Dex without unduly impeding competition from Competitive Local Exchange Carriers ("CLEC").

Q. WHAT ARE YOUR CONCLUSIONS REGARDING THE PROPER REGULATORY TREATMENT OF THE QWEST DEX SALE?

A. The assets that generate the value of Qwest Dex's business are "assets" that have not been included in ratebase.[3] The assets at issue are not of the kind on which the traditional regulatory bargain of cost-of-service regulation allows shareholders the protected opportunity to earn a return in exchange for caps on the prices realizable in the business. Thus, ratepayers have not borne the burden of Qwest Dex's productive assets, and sharing of gains should be designed to minimize the impact on the competitive process in

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[2] ***See, e.g.,*** *Application of Avista Corporation, et al., for Authority to Sell Its Interest in the Coal-Fired Centralia Power Plant*, WUTC Consolidated Docket Nos. UE-991255, UE-991262, UE-991409, Second Supplemental Order, Order Approving Sale with Conditions, at ¶ 29.

[3] For example, Dex's FAS 141 analysis for the eastern portion of the transaction shows that **[Begin Highly Confidential>***<End Highly Confidential]** Murray Devine & Company "FAS 141 Analysis of Dex Media East, Inc. as of November 8, 2002," a copy of which is provided with the Rebuttal Testimony of William E. Kennard ("Kennard") at Exhibit ___ WEK-3HC.

local exchange markets. These considerations indicate that Qwest's recommendation for time-limited imputation of a specific amount of the sales proceeds to the ILEC's rates (per Qwest witness Reynolds) is consistent with these principles of sound public policy.

The telecommunications industry is well down the path toward competition, and the directory business is facing increasing competition from independent yellow pages directories, the internet, and other media. Thus, the value of the yellow pages business is driven by management's incentives and ability to respond to these competitive forces. Representations (e.g., by Dr. Selwyn) of Qwest Dex's value as being solely the legacy of its prior regulated history are internally contradictory and incorrect as a matter of economics. Moreover, in an increasingly competitive environment, perpetuation of the policy of imputation is not consistent with the efficient operation of Qwest Dex's yellow pages business.

Q. WHAT ARE YOUR FINDINGS WITH RESPECT TO THE ADEQUACY OF THE SALES PRICE OF THE BUSINESS IN QUESTION?

A. My analysis of the $7.05 billion sales price of Qwest Dex indicates that this amount accurately reflects the fair market value of the business ("business enterprise value") and that the sale is not properly characterized as a distress sale. QCI engaged in a process to sell Qwest Dex that continued for at least four months. The sales process elicited responses from multiple buyers, with some potential buyers eventually dropping out of the process because the price was considered to be too high. These factors are not consistent with the assertion that Qwest Dex was sold in a distress sale.

The mere fact that QCI sought to sell Qwest Dex because it wanted cash to address its financial difficulties does not mean that the sale was a "distress" sale or otherwise failed to elicit the fair market value of the assets in question. It is commonplace for businesses to sell assets, subsidiaries, and divisions in order to improve their financial situations. In this case, the workings of the sale process indicate that

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Qwest took the time to develop a sound process that generated competition among potential buyers, reflecting Qwest's interest in obtaining as high a price as possible for the asset. The exit of the winning bidder's partner from the sales process indicates that no money was left on the table by the seller.[4]

Based on the above considerations, I find that QCI has obtained a price that reflects the fair market value of Qwest Dex. By implication, Qwest witness Reynolds is correct to use the actual sales price as the basis for sharing gains with ratepayers.

Q. HOW IS YOUR TESTIMONY ORGANIZED?

A. A key question in determining whether the sale of Qwest Dex is in the public's interest is whether QCI obtained fair market value for the business. Therefore, I turn to the question of the fair market value of the directory business first. I then turn to the question of whether the sale of the directory business for its fair market value is in the public's interest and to the question of what value is contributed to Qwest's directory business by shareholders and ratepayers.

III. FAIR MARKET VALUE OF QWEST DEX

Q. PLEASE DESCRIBE THE CONCEPT OF "FAIR MARKET VALUE."

A. In this context, fair market value is the value of a good, service, or, as in this case, a business obtained when it is sold in open commerce between a willing buyer and a willing seller under competitive circumstances. When a business is sold under competitive circumstances, the value is considered fair because it reflects what the market forces of supply and demand indicate the business is worth in light of available information, risk and uncertainty, and the terms and conditions of the sale. Sales taking place under such circumstances reflect prices that are as high as the sellers are actually and reasonably able to obtain in the marketplace. Importantly, as described more fully

4 Kennard at 5-6.

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below, where there is competition among potential buyers to purchase a productive asset, the motivations of the seller for selling the asset do not provide buyers a basis for making offers below fair market value.

Q. DR. SELWYN ASSERTS THAT QWEST SOLD QWEST DEX IN A "DISTRESS SALE."[5] DO YOU AGREE WITH THIS CHARACTERIZATION?

A. No. Dr. Selwyn's characterization of this transaction as a "distress sale" rests on the view that because Qwest is in the position of needing an infusion of cash in the near future, potential buyers were in the position to drive the terms of the deal. Thus, Dr. Selwyn argues that Qwest's recognized need for cash created a "buyers market" and "placed QCII at a distinct disadvantage relative to potential bidders when trying to negotiate the highest possible sale price for [Qwest] Dex."[6]

Dr. Selwyn's conclusions are not consistent with sound economic analysis. He has not properly analyzed the competitive nature of the Qwest Dex sale to determine whether QCI was at a "disadvantage relative to potential bidders." A distress sale is one where a buyer is able to take advantage of a seller's distress. However, in order for a buyer to take advantage of a distressed seller, the buyer must be in a position to make a "take it or leave it," below-market offer that the seller would not take but for its distress. Where there is competition for the asset being sold, however, a buyer will not be in a position to make such a "take it or leave it" offer to a seller because competing buyers would readily outbid such an offer. It is simply unsound economic reasoning for Dr. Selwyn to assert that Qwest is a company in distress and therefore the sale of Qwest Dex is a distress sale. When a productive asset is sold under conditions and procedures

5 Direct Testimony of Lee L. Selwyn ("Selwyn") at 6.

6 Selwyn at 16-17. ***See also*** Direct Testimony of Michael L. Brosch ("Brosch") at 13. Dr. Brosch ultimately accepts the market-determined sales price for purposes of his analysis. ***See*** Brosch at 53-54.

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that are designed to – and in this case, demonstrably did – elicit competition among buyers for that asset, such a sale is not properly characterized as "distress."

Q. WAS THE PROCESS QCI EMPLOYED FOR SELLING QWEST DEX APPROPRIATE FOR ELICITING THE FAIR MARKET VALUE OF QWEST DEX?

A. Yes. QCI engaged a number of investment banks to examine different approaches to generating cash from QCI's directory business. These included selling the business in a public offering, issuing a tracking stock, and selling the business in a leveraged buyout. Thus, the evidence indicates that QCI made a thorough investigation of the best means to realize the full value of the directory business. The result of this analysis was that QCI decided to offer the directory business for sale in a competitive sales process run by its investment bankers. In fact, QCI turned down an early offer for Qwest Dex from Kohlberg, Kravis, Roberts & Co. ("KKR") in order to proceed with its plan to use its bankers to run a competitive process to sell the business.

QCI's bankers were successful in stimulating significant interest in purchasing the business. In the initial phases of the sales process, 39 parties signed confidentiality agreements and received descriptive memoranda. After consortia formed among certain potential buyers, QCI received eight first-round bids. Four bidders were invited to continue in the second round of bidding.[7] Throughout the process, the buyer ultimately selected (The Carlyle Group ("Carlyle") and Welsh, Carson, Anderson & Stowe ("WCAS")) faced competition from other potential buyers of the business. Moreover, Carlyle/WCAS recognized the competition and bid in response to the competition.[8]

[7] Qwest Response to ATG 01-0051, Confidential Attachment D at 8.

[8] Kennard at 2-3.

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Q. IS IT YOUR OPINION THAT THIS PROCESS RESULTED IN A SALE PRICE FOR QWEST DEX THAT REPRESENTS THE FAIR MARKET VALUE OF THE BUSINESS?

A. Yes. It is clear from the economic evidence that QCI and its bankers managed to generate and maintain competitive circumstances throughout the sales process, and that the competition among buyers protected QCI's interests, resulting in a price reflecting fair market value. This evidence includes:

- **Extended Sales Process**: The bidding process extended over several months, with the descriptive memoranda being sent in April, and the final decision not being made until August. Such an extended process is not consistent with the notion of a 'distressed' seller desperate for cash.
- **Rejected Offer**: As noted, QCI rejected an offer from a group of firms led by KKR before the bidding process began. Rejecting an offer from a credible buyer is not behavior that is consistent with a firm engaged in a distress sale.
- **Multiple Bidders**: It was widely reported in the press that there were several potential buyers bidding on all or part of Qwest Dex. The presence of multiple buyers bidding for this asset makes the assertion that the buyers were able to in some way take advantage of Qwest's financial position implausible. The buyers were actively competing against one another to offer Qwest the most attractive deal. In fact, the ultimate buyer repeatedly enhanced its bid up to the last minute.[9]
- **Pricing Pressure**: If the price being offered by Carlyle/WCAS were significantly below the market value of Qwest Dex, then no member of the initial buyer consortium of Carlyle/WCAS and Madison Dearborn Partners

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[9] Kennard at 3-4.

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("Madison") would have had an incentive to leave the consortium. However, the increased offers Carlyle/WCAS/Madison had to make in the final stages of bidding exerted sufficient financial pressure on the buying group that Madison chose to walk away from the deal.[10] In "proof is in the pudding" fashion, there is no evidence that money was left on the table by the seller.

Q. ASIDE FROM HIS ASSERTION THAT QCI'S NEED FOR CASH PLACED IT AT A DISADVANTAGE RELATIVE TO POTENTIAL BUYERS, DOES DR. SELWYN ASSERT OTHER FACTORS THAT PURPORTEDLY PREVENTED QCI FROM RECEIVING THE FAIR MARKET VALUE OF ITS DIRECTORY BUSINESS?

A. Yes. QCI's investment bankers, Lehman Brothers and Merrill Lynch, created presentations, dated August 19, 2002, that present their estimates of a number of different ranges of value of Qwest Dex in various types of transactions.[11] Based on the ranges provided in the Lehman Brothers presentation, Dr. Selwyn finds that the actual sales price of Qwest Dex **[Begin Confidential>** ****************************[12]<**End Confidential]** More specifically, Dr. Selwyn asserts that the sales price is **[Begin Confidential>******************************** **[13]<**End Confidential]** Thus, Dr. Selwyn's analysis implies that QCI should have obtained the average of the midpoints of the ranges of value as a sales price.

Q. DOES DR. SELWYN'S ANALYSIS SUPPORT THE CONCLUSION THAT QCI FAILED TO GET FAIR MARKET VALUE FOR ITS DIRECTORY BUSINESS?

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[10] Kennard at 5.

[11] Qwest Response to ATG 01-005, Confidential Attachments C and D.

[12] Selwyn at 26-27.

[13] Selwyn at 28, Table 1.

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A. No. There is no foundation in economics for Dr. Selwyn's assertion that the **[Begin Confidential>*** ******<End Confidential]** is the appropriate quantification of fair market value or the business enterprise value of an asset. Dr. Selwyn's assertion that a price **[Begin Confidential>***<End Confidential]** is below the full fair market value of the asset directly implies that a price above such a level would indicate that the buyer paid above the fair market value of the asset. In fact, where the **[Begin Confidential>***********************<End Confidential]** of a business is an unbiased estimate of the value that business will fetch in the marketplace, then the actual value found in the marketplace will be **[Begin Confidential>** **************** <End Confidential]**

Q. DO THE ANALYSES DR. SELWYN RELIES UPON SUPPORT THE CONCLUSION THAT THE VALUE OF A BUSINESS SHOULD BE EXPRESSED AS A RANGE, AS OPPOSED TO THE SINGLE VALUE SELECTED BY DR. SELWYN?

A. Yes. In the case of the Lehman Brothers' analysis, the chart referenced by Dr. Selwyn presents a range of values for different scenarios and does not present a single valuation for any one scenario.[14] Thus, the value of Qwest Dex is expressed explicitly as a range. This is consistent with the basic economics of valuation. Every estimate of value has a confidence interval or range of values associated with it (explicitly or implicitly). This is the necessary result of the uncertainty surrounding how the market will value any particular asset, stemming from unknown future market conditions, uncertainty surrounding cash flow forecasts for the company, uncertainty regarding risks, etc. Because of these uncertainties, it is not possible as a matter of economic logic to provide

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[14] Selwyn at 26-27 and Table 1 at 28. Qwest Response to ATG 01-005, Confidential Attachment C at 13.

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an estimate of fair market value that does not explicitly or implicitly include a range of values such that a transaction value within that range reflects fair market value.

Q. IS DR. SELWYN'S ANALYSIS OF OTHER INVESTMENT BANKERS' INFORMATION SOUND?

A. No. Dr. Selwyn attempts to support his conclusion that the price achieved for Qwest Dex is below the full fair market value of the business by reference to older valuation analyses produced by QCI's bankers.[15] These analyses, however, are based on information that was out of date as of the time of the transaction. In particular, Qwest Dex's business experienced some softness in the first half of 2002, leading to reductions in forecasts of EBITDA (earnings before interest, taxes, depreciation, and amortization). Thus, these out-of-date analyses and any calculations based on them cannot shed additional light on the value of Qwest Dex on a stand-alone basis at the time of the actual sale.

IV. PUBLIC POLICY ANALYSIS OF THE PROPOSED SALE

Q. WHAT IS DR. SELWYN'S STANDARD FOR ASSESSING THE "PUBLIC INTEREST" IN THIS PROCEEDING?

A. Dr. Selwyn asserts that: "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."[16]

Q. IS THIS STANDARD CONSISTENT WITH SOUND ECONOMIC REASONING?

A. No. Notice that Dr. Selwyn's proposed standard focuses on QC's Washington ratepayers. He concerns himself with neither the totality of telecommunications

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[15] Selwyn at 29 and 32-34.

[16] Selwyn at 5, (emphasis in original).

consumers in Washington nor the totality of the citizens of Washington. This narrowness is inappropriate. The proposed ratepayer-impact standard does not account for the full spectrum of issues that define the public's interest.[17] This standard wrongly (and anachronistically) equates the public's interest with the interest of remaining retail customers of regulated telephone service, and completely ignores the fact that Congress, the FCC, and the State of Washington have adopted policies of promoting competition in retail markets for local exchange services.[18]

The Washington public has an abiding interest in the sound functioning and regulation of the markets for local exchange services. Thus, where there is a policy of moving toward the use of competitive forces to determine what services will be offered and to discipline the prices of those services, the public's interests in the long term will be served by policies that promote effective local exchange competition. Policies supporting price reductions that are only for telecommunications consumers/ratepayers who remain with the ILEC and that are funded with revenues garnered from services purchased by others (e.g., directory advertisers) are not competitively neutral and portend continuing un-leveling of the competitive playing field in the ILEC's favor.[19] This cannot have a positive impact on the development of competition and the dynamism of the competitive process. For at least consumers/ratepayers who seek competitive

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[17] ***See, e.g.***, *Application of Avista Corporation, et al. for Authority to Sell Its Interest in the Coal-Fired Centralia Power Plant*, WUTC Consolidated Docket Nos. UE-991255, UE-991262, UE-991409, Second Supplemental Order, Order Approving Sale with Conditions at ¶ 29.

[18] ***See, e.g.,*** Telecommunications Act of 1996 at Sections 253 (a) and 253 (b); *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, FCC Consolidated Docket Nos. 96-98 and 95-185, FCC Order No. 96-325 at ¶¶ 1-3, 11 FCC Rcd. 15,499; Statement of Reed E. Hundt, Chairman of the FCC, on Implementation of the Telecommunications Act of 1996, before the Subcommittee on Telecommunications and Finance, Committee on Commerce, U.S. House of Representatives, July 18, 1996; RCW 80.36.300; *WUTC –v- U.S. West Communications, Inc.*, WUTC Docket No. UT-950200, Fifteenth Supplemental Order, Commission Decision and Order Rejecting Tariff Revisions; Requiring Refiling, at 9.

[19] Telecommunications Act of 1996 at Sections 253(a) and 253(b).

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alternatives, and even for consumers who stay with the ILEC, the implications for service offerings, efficiency, and even ultimate rates are contrary to those parties' interests.

The recognition that competition will be beneficial to local telecommunications consumers/ratepayers reflects the fact that consumers receive various benefits from competition. These benefits arise from the impact of competition on both the price and the quality of services, and from expanding consumers' choices of service offerings from various competitors. The adoption of a policy promoting competition is indicated where the forces of competition have the potential to drive prices down and quality and service offerings up relative to what cost-of-service regulation can achieve. Competitive markets are inherently dynamic in terms of pricing, quality, and the range of service offerings. This dynamism appropriately makes it difficult to predict market responses in the future, as ILECs and CLECs take up the challenges of competition and seek to attract customers. What is clear is that the narrowness of Dr. Selwyn's approach, with its short-run perspective and focus on only a subset of Washington's citizens and telecommunications consumers/ratepayers, is contrary to the Washington public's long-run interests.

Q. WHAT IS YOUR ASSESSMENT OF QWEST'S PROPOSALS FOR TIME-LIMITED IMPUTATION OF "GAINS" FROM THE SALE OF QWEST DEX?

A. Following the breakup of the Bell system, the WUTC's use of imputation (or the equivalent) was an understandable response to the restructuring of the industry and the transition to a more dynamic and competitive setting. However, in the presence of sound and clearly established goals of enhanced competition and reliance on marketplace forces for determining the quality, packaging, and pricing of local exchange services, the public's interest is not served by perpetual use of cash flows from an unregulated business to reduce prices charged by the ILEC as it competes with competitive carriers. In fact, if the policy of promoting competition were successful, the very success of the policy would eliminate the basis for imputation entirely. For this reason, and others, it is

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not proper to enact policies today based on the false presumption that imputation can or should continue indefinitely into the future.

Q. WHAT ARE THE IMPLICATIONS OF THE PUBLIC'S LONG-TERM INTEREST IN ELIMINATING THE COMPETITION-DISTORTING EFFECTS OF THE CURRENT POLICY OF IMPUTATION?

A. Where imputation cannot, under current policy, continue effectively forever, and where events (e.g., increased yellow pages competition) necessarily inhibit the WUTC's ability to retain the value of Qwest Dex for ratepayers in the future, approval of the sale of Qwest Dex, with proper account of ratepayer interests, is indicated. Moreover, as described above, the sale price of Qwest Dex provides a sound basis on which to evaluate ratepayer interests in the proposed transaction.

Q. BASED ON THESE CRITERIA, DO YOU FIND THAT THE PROPOSED TRANSACTION IS IN THE PUBLIC INTEREST?

A. Yes. The approval of the transaction with the sharing of gain proposed by Qwest witness Reynolds would bring to an end the current imputation arrangements, which likely have a distorting effect on competitive markets, including markets for advertising and for local exchange telephone service. Thus, the QC proposal provides for the interests of ratepayers both by providing them with some of the gain on the sale of the directory business and by supporting their long-term interests in an improved environment for local exchange competition.

Q. DR. BLACKMON SAYS THE SALE OF QWEST DEX IS AN EFFORT BY QC TO GIVE "AN UNFAIR COMPETITIVE ADVANTAGE" TO ITS UNREGULATED PARENT COMPANY.[20] IS THIS A PROPER ANALYSIS OF THE PROPOSED TRANSACTION?

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[20] Direct Testimony of Glenn Blackmon ("Blackmon") at 18-19.

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A. No, it is not. Concerns do arise where competitive and regulated businesses exist within the same larger company. In such situations, it is appropriate for regulators to guard against the shifting of costs from unregulated lines of business to regulated businesses in an effort to increase profits in the unregulated portion of the business. The proposed transaction, however, does not raise this risk. The issue before the WUTC is the determination of the appropriate sales price and compensation for Washington ratepayers. Once ratepayers are appropriately compensated for their contribution to the value of the directory business, the issue of cross-subsidization and its potential harm to ratepayers disappears.

Dr. Blackmon is also mistaken that QCI's ability to generate cash from other businesses gives it an unfair advantage in its competition against other telecommunications companies in unregulated lines of business. The need for cash has to do with the financing needs of QCI, as described by Qwest witnesses. There is no evidence from WUTC Staff or Public Counsel that the cash will or even could be used for anticompetitive purposes.

Dr. Blackmon's concerns regarding the negative impact of the reduction of costs through the transfers of money among businesses, however, would apply to the harmful impact on competition of imputation on prices charged by QC for local exchange service.

Q. STAFF WITNESSES SUGGEST THAT IF THE WUTC REJECTS THE TRANSACTION, THEN QC RATEPAYERS CAN CONTINUE TO RECEIVE THE BENEFITS OF IMPUTATION INDEFINITELY. IS THIS SOUND REGULATORY POLICY?

A. No. Even if the WUTC desires to follow Staff witnesses' advice and continue the current imputation indefinitely, there is uncertainty surrounding the future basis for imputation. While directory revenues have grown in past years and may grow over the next several years, there is little doubt that Qwest Dex faces increasing competition from independent

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yellow pages, internet yellow pages, and internet sites. Moreover, the threat of bankruptcy creates some uncertainty regarding the WUTC's future control over the directory assets of QCI.[21] These uncertainties militate toward a policy that protects all ratepayer interests for the long run and resolves the question of their interest in yellow pages cash flows once and for all.

Q. STAFF WITNESS BLACKMON ASSERTS THAT "[I]F WASHINGTON DISAPPROVES THE TRANSACTION, QWEST CAN MAKE A BUSINESS DECISION ABOUT WHETHER TO RENEGOTIATE THE SALE TO EXCLUDE WASHINGTON."[22] IS THIS SOUND ECONOMIC ADVICE TO THE WUTC?

A. No. Even if perpetual imputation were appropriate (which it is not), such a strategy could not be predicted to preserve the levels of imputation Washington might forecast under its past policies. First, the valuation analyses surrounding the possible breaking up of Qwest Dex into two pieces indicate that there are some dis-synergies associated with doing so.[23] Thus, a Washington-only directory business would not produce the same imputation as the Washington share of a larger directory operation.

In addition, it is clear that the sources of value in the current advertising environment arise from the ability of the business to meet increased competition from independent publishers, the internet, and other sources. Businesses operating under cost-of-service regulation or imputation requirements that amount to 100 percent marginal tax rates cannot be expected to meet these challenges effectively. Effective regulation of a Washington-only directory business would have to include some incentive for management to meet the challenges of the market effectively and to control costs.

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[21] Rebuttal Testimony of Ralph R. Mabey at 7-12.

[22] Blackmon at 23.

[23] ***See, e.g.***, Qwest Response to ATG 01-005, Confidential Attachment D at 1, note 4.

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Without such incentives, market performance could be expected to suffer, costs to rise, and Qwest Dex's market-leading EBITDA margins to fall.

Thus, even under Staff's "go it alone" strategy for Washington, the WUTC's options in this instance do not appear to include the protection of the full amounts of imputation indefinitely into the future.

Q. DR. BLACKMON SUGGEST THAT THE WUTC COULD (OR SHOULD) ORDER QC TO ENTER INTO A DIRECTORY PUBLISHING AGREEMENT THAT WOULD "COMPENSATE QWEST CORPORATION FULLY FOR THE ECONOMIC VALUE OF THE DIRECTORY FRANCHISE."[24] IS THIS SOUND POLICY ADVICE?

A. No, I don't believe it is. In addition to the policy considerations I have already discussed, Dr. Blackmon's conclusion is inconsistent with the evidence on the value of the Washington directory "franchise." Dr. Blackmon's argument is based on the assumption that the value of the directory business is contained in the publishing agreement and the non-compete agreements.[25] This conclusion, however is not consistent with the analysis Dex commissioned to support its FAS 141 accounting obligations attendant to the purchase of the Dex Media East or "Dexter" transaction. As Mr. Kennard indicates, Dex retained Murray Devine & Co. to value the intangible assets purchased by Dex. Murray Devine & Co.'s valuation shows that the value of the non-competition and publishing agreements together is approximately **[Begin Highly Confidential>**************
** [26]**<End Highly Confidential]**

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[24] Blackmon at 23.

[25] ***See also*** Blackmon at 25, "it is the QC publishing and non-competition agreements that create the value in this transaction." Dr. Selwyn makes similar assertions. See Selwyn at 90-91.

[26] Kennard at 12; Murray Devine & Company "FAS 141 Analysis of Dex Media East, Inc. as of November 8, 2002" at Exhibit ___ WEK-3HC.

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Thus, Dex's FAS 141 analysis shows that the agreements that are purported to contain the value of Qwest Dex's directory business by preserving the connection of the directories to the legacy LEC are not the actual source of business value Dex purchased. This analysis indicates that rather than being in a position to enter into a publishing and non-competition agreement that would fully protect the value of imputation as it would be calculated today, QC would not be expected to be able to enter into a publishing agreement that yielded value of more than approximately **[Begin Highly Confidential>*** *******************************<End Highly Confidential]** Even if such payments went on indefinitely, they would effectively never provide the value of the $103 million per year for 10 years that Qwest is proposing as gain sharing.

As noted, Staff's witnesses have asserted that much or all of the value in the Qwest Dex purchase is contained in the publishing agreement and non-competition agreement. However, these agreements are standard business arrangements and could be expected to be part of any such sale – whether the seller was a former regulated monopolist or not. To the extent these agreements sustain the connection between the directories in the future and the ILEC, their being part of the agreement and the value independent analysts have placed on them do not support the conclusion that retained connection to the formerly regulated ILEC is the source of value attendant to the sale of Qwest Dex. Rather, for almost 20 years, the directory business has had to contend with the business challenges of increasing competition, changing technology, and dynamic industry structures. Going-forward productive activities and value associated with such factors as advertiser identities and even the concept of "yellow pages" must per force be related to Qwest Dex's relative success in meeting these challenges up through 2002 (rather than to a legacy of monopoly regulation that Staff's witnesses appear to see as unending in the face of change).

Q. DOES DR. SELWYN PROVIDE A METHODOLOGY FOR THE WUTC TO USE IN DECIDING HOW TO ALLOCATE PROCEEDS FROM THE QWEST DEX SALE BETWEEN RATEPAYERS AND SHAREHOLDERS?

A. Dr. Selwyn argues that the ratepayers' entitlement to value from the Qwest Dex sale is based on the extent to which the value of Qwest Dex is derived from the regulatory legacy of the directory business.[27] Dr. Selwyn asserts that the value of the directory business is the direct result of Qwest Dex's relationship with the local telephone company.[28] He goes so far as to claim that Qwest Dex has a "near-monopoly" in the directory business as a result of this relationship.[29] Based on these assertions, Dr. Selwyn concludes that all of the value of Qwest Dex belongs to QC and the proceeds of the Dex sale should go to QC's ratepayers.

However, even Dr. Selwyn seems to recognize that any benefit Qwest Dex received from the regulatory legacy is not a monopoly in the directory business, but rather first mover advantage.[30] Specifically, Qwest Dex derives value because it publishes the largest directory in many of the markets it serves, and thus Qwest Dex – along with its advertisers and other users of Qwest Dex directories – receives positive network benefits.

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[27] ***E.g.,*** "As I have explained, the circumstances under which the directory publishing activity have [*sic*] 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." Selwyn at 68.

[28] ***E.g.,*** "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." Selwyn at 82. Other witnesses make the same argument. ***See, e.g.,*** Dr. Blackmon: "[T]here is little or no economic value in the directory publishing business if it is separated from the telephone company." Blackmon at 16.

[29] Selwyn at 64.

[30] Selwyn at 85-86.

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Further, a first mover advantage does not convey monopoly status on Qwest Dex, as evidenced by the fact that Qwest Dex faces entry competition from other directory providers in virtually all the markets it serves.[31] Indeed, evidence shows that traditional yellow pages providers face increasing competition from independent yellow pages providers as well as other media (e.g., internet yellow pages, internet websites).[32]

Nor is even a first mover advantage the sole source of Qwest Dex's value. Other factors besides this advantage have clearly added value to Qwest Dex (e.g., sound management, maintenance and continued development of the intangible assets at issue in this proceeding, etc.) and have permitted Qwest Dex to retain the value of its business over the last 20 years. As Dr. Selwyn acknowledges, the directory business has changed in many respects since 1983.[33] The assets that constituted the directory business in 1983 are very different from the Qwest Dex assets today. In fact, Dr. Selwyn asserts that expanding competition, not continued regulatory protection or the legacy of regulation, is driving the volume of relevant advertising upward.[34] This is wholly inconsistent with his assertion that the present and future fate of Qwest Dex is solely the product of its prior regulatory treatment.

Similarly, Dr. Blackmon's conclusion that "it is the QC publishing and non-competition agreements that create the value in this transaction"[35] is also flawed. As described above, Dex's FAS 141 valuation analysis for the "Dexter" assets placed

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[31] ***See, e.g.,*** Qwest responses to WUTC 2-006I and 2-007I.

[32] ***See, e.g.,*** Lehman Brothers, "Qwest Dex at the Crossroads: Invest for Growth or Harvest and Decline," Exhibit No.___(LLS-13C), at 5-9.

[33] Selwyn at 100.

[34] Selwyn at 50-51 (citing Lehman Brothers, "Qwest Dex at the Crossroads: Invest for Growth or Harvest and Decline").

[35] Blackmon at 25. ***See also*** Brosch at 35-37.

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[Begin Highly Confidential>************************************ *************[36]<End Highly Confidential]**

In sum, it is clear that Dex's value is not derived entirely from Qwest Dex's regulatory legacy or its relationship with QC. Thus, Dr. Selwyn's recommendation that ratepayers are entitled to the entire Qwest Dex enterprise value is not supportable on its own terms. The QC proposal to share the proceeds of the sale between shareholders and ratepayers is appropriate.

Q. HAVE QC RATEPAYERS IN WASHINGTON BORNE A REGULATORY BURDEN AS A RESULT OF THE IMPUTATION PROCESS?

A. No. Imputation has operated only as a means for allocating revenues from the directory business to Washington ratepayers and to shareholders. The WUTC has not used the imputation process to set prices for yellow pages advertising. The imputation procedure has never presented a risk to ratepayers that their rates would increase to compensate QC for revenue shortfalls in the directory business. In the (albeit unlikely) event that yellow pages costs exceeded yellow pages revenues, it is highly unlikely that the WUTC would have raised rates for local exchange service in order to make QC shareholders whole. QC ratepayers have not borne any risk associated with the potential "stranded cost" of directory services.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes. Thank you.

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[36] Murray Devine & Company, "FAS 141 Analysis of Dex Media East, Inc. as of November 8, 2002" at Exhibit ___ WEK-3HC.

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