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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

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REBUTTAL TESTIMONY OF

WILLIAM E. KENNARD

ON BEHALF OF

DEX HOLDINGS LLC

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APRIL 17, 2003

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I. INTRODUCTION AND BACKGROUND

2 Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS FOR THE
3 RECORD.
4 A. My name is William E. Kennard. I am employed as Managing Director of the
5 Telecommunications and Media Group of The Carlyle Group ("Carlyle"). My
6 business address is 1001 Pennsylvania Avenue, N.W., Washington, D.C. 20004.
7 Q. DID YOU PREVIOUSLY OFFER DIRECT TESTIMONY IN THIS CASE?
8 A. Yes, I filed direct testimony in this case before the Commission on January 17, 2003.
9 Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?
10 A. Today, I intend to address three areas. First, I will describe the process surrounding
11 the sale of Dex from the perspective of Carlyle and Welsh Carson Anderson &
12 Stowe ("WCAS"), showing that we paid as much as we were prepared to pay for this
13 asset and rebutting the claims of Mr. Brosch and Dr. Selwyn that the auction for Dex
14 was not competitive. Second, I will explain my view that Qwest Corporation's
15 ("QC's") customers are well served by the sale of Dex at this time, and correct Dr.
16 Blackmon's apparent misunderstanding of my direct testimony on the point of
17 increasing risk. Third, I will explain why I believe that, contrary to the testimony of
18 Dr. Selwyn, Ms. Folsom, and Dr. Blackmon, it would be contrary to the public
19 interest for the Commission to reject the Dex sale, either directly or with
20 unacceptable conditions, because such a decision would significantly increase the
21 risk of ratepayer harm.
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II. THE COMPETITIVE NATURE OF THE SALE OF DEX

23 Q. PLEASE DESCRIBE HOW YOU BECAME INVOLVED IN THE SALE OF DEX.
24 A. In April, 2002, Lehman Brothers, acting on behalf of Qwest Communications
25 International Inc. ("QCI"), contacted us to indicate that QCI had reached a decision
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to sell the Dex directory publishing business and to explore our interest in purchasing it. My understanding is that Qwest contacted a large number of additional potential buyers in the same manner, including private equity investors, competing independent publishers, LEC publishing affiliates, and other media companies.

To raise the necessary capital, Carlyle partnered with WCAS and an additional firm, Madison Dearborn Partners. On May 8, 2002, the three firms jointly submitted a non-binding proposal to purchase Dex. On the basis of this initial proposal, we were among a group of firms invited to conduct additional diligence on Dex and proceed to the next round of bidding. Four months after receiving the initial contact, in August, 2002, we emerged as the successful bidder for the Dex business.

Q. WAS THE BIDDING PROCESS COMPETITIVE?

A. Yes, absolutely. Although Qwest was widely reported to be facing financial and accounting difficulties at the time, Dex represented a quality asset, even in light of challenges on the horizon for the directory publishing business. As a result, there was a great deal of interest among financial and strategic investors. Although QCI did not formally tell us the identity of the other bidders or how many there were, we knew that the process was highly competitive based on information we received from various other sources. Because the sale promised to be the largest leveraged buyout (“LBO”) in over two decades, and because of the size and prominence of QCI, the sale generated a great deal of media interest. News reports at the time indicated that numerous bidders had made initial bids. The bidders included several of the largest and best-funded private equity firms in the world, including Kohlberg Kravis Roberts & Co.; the Blackstone Group; Thomas H. Lee Partners; Providence Equity Partners; Bain Capital; Goldman Sachs; CSFB Private Equity, Oaktree Capital Management; the Apollo Group, Texas Pacific Group; Hicks, Muse, Tate &

Furst; Apax Partners; CSFB Private Equity, and possibly others. Industry bidders, including Liberty Media and the R. H. Donnelley Corporation were also reported to have made offers.

Q. DID THE FACT THAT QCI WAS SEEKING ALL-CASH OFFERS FOR DEX DAMPEN COMPETITION AMONG POTENTIAL BUYERS, AS MR. BROSCH SUGGESTS? (BROSCH AT 53.)

A. Not at all. While this is the largest LBO in the past 20 years, there are a large number of entities that have the ability, alone or as part of a consortium of investors, to raise the necessary capital. Despite QCI's requirement of an all-cash offer, there were an abundance of willing and able private equity investors that did participate.

Q. YOU SAY THAT DEX WAS A QUALITY ASSET. DO YOU MEAN YOU DISAGREE WITH MR. BROSCH'S (AT 16) AND DR. SELWYN'S CONCLUSION (AT 6, 39) THAT THIS WAS A "DISTRESS SALE" OF DEX?

A. Yes, I strongly disagree. Mr. Brosch states his belief that the final purchase price "appears to be reflective of the financial distress being experienced by Qwest." (Brosch at 13.) Similarly, Dr. Selwyn testifies that "[t]he transaction is clearly a 'distress sale' that is to take place at a 'distress price.'" (Selwyn at 6.) Nothing could be further from the truth. QCI's financial difficulties did not affect our negotiation or bidding strategy. Because Dex itself was such an attractive asset, we believed that the bidding competition would be fierce and, indeed, it was. I therefore strongly disagree with Dr. Selwyn's theory that bidders were factoring Qwest's distress into their bids. (Selwyn at 16, 23.)

Market dynamics make it easy to see why Dr. Selwyn's analysis is fundamentally flawed. Let's suppose one bidder were to act as Dr. Selwyn suggests,

1 attempting to capitalize on Qwest's distress by offering a below-market price for
2 Dex. Another bidder would immediately top the bid by foregoing some portion of
3 the difference between the first bid and the second bidder's perception of the true
4 market value of Dex. Eventually, the gap would be entirely consumed and the forces
5 of market competition would push the bids for Dex inexorably toward its true fair
6 market price.

7 That market dynamic was at work in the Dex sale, without regard for Qwest's
8 financial circumstances. In participating in the negotiations, our thoughts were on
9 the competing bidders, and not on Qwest's financial difficulties. Right up to the
10 final minutes before we signed the purchase agreements with QCI, we knew that we
11 were competing against at least one other bidder, and that Qwest was prepared to
12 execute a purchase agreement with that competitor if our offer were not superior.

13 Few, if any, companies undertake the process of divesting a substantial asset
14 without substantial strategic, financial, or other reasons for doing so. The transaction
15 costs associated with doing so are simply too high. Thus, it is commonplace in
16 M&A transactions for a prospective purchaser to face a motivated seller. The degree
17 and source of a seller's motivation, however, does not affect the amount we are
18 willing to bid in seeking any particular acquisition in a competitive environment.
19 Rather, our analysis must focus on the fundamental market value of the asset, as
20 revealed by the cost and revenue structure of the business, the cost of the capital
21 needed to complete the acquisition, and other factors related to our ability to operate
22 the business successfully and profitably after the sale closes.
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Q. WHAT ABOUT THIS CASE? DID YOU ACQUIRE DEX AT A "BARGAIN" OR "DISTRESS SALE" PRICE?

A. Absolutely not. To the contrary, Qwest pushed us to the edge of what we could possibly have paid for the Dex business. Indeed, often we were not certain that we could emerge as the winning bidder because of the stiff competition from other parties. Right up to the last minute, we still faced stiff competition. Indeed, in the minutes before we signed the purchase agreement on August 19, 2002, we were forced to increase our bid by $50 million and agree to absorb additional costs to close the deal. There are far fewer acquisition opportunities today than there were even a few years ago, leading to greater competition for the limited number of attractive acquisition targets that do exist.

Beyond the vibrant competition that characterized the negotiations for the sale of Dex, there are several reasons why I believe that the sale of Dex took place for its full market price. First, in the case of the Dex sale, one of our partners in the initial consortium, Madison Dearborn Partners, withdrew as a result of the elevated prices that Dex was commanding.

Second, it is unlikely that Carlyle and WCAS could have successfully executed the transaction at any substantially higher price. We are financing a substantial portion of the Dex acquisition with high-yield bonds. Throughout the summer of 2002, however, debt capital markets steadily worsened, particularly in the high yield area. Credit spreads—*i.e.*, the difference between the implied interest rate on high yield bonds and U.S. Treasury bonds of comparable maturity dates—widened. We will have to repay investors in the bonds we issue from the revenues generated from Dex's directory operations. The higher interest rates from the widening credit spreads reduced the level of debt that Dex's revenue can support.

1 Just as when home mortgage interest rates rise, a homebuyer cannot afford as large a
2 mortgage while remaining within a budgeted monthly mortgage payment, buyers
3 could not afford to increase their bids for Dex at a time when the ability to secure
4 high-yield bond financing at acceptable rates was declining. Indeed, we were only
5 able to sustain our bid price of $7.050 billion after Qwest agreed to grant us the
6 option to obtain $300 million in financing for the transaction from Qwest. This
7 seller commitment was a critical piece of the overall purchase agreement. Further,
8 the fact that we could not rely on our ability to obtain complete financing for the Dex
9 transaction in the debt capital markets indicates a belief among the participants in
10 those markets that Dex was worth no more than we were already offering to pay.
11 Third, and finally, Qwest did an outstanding job of keeping the pressure on us
12 to increase the attractiveness of our bid relative to other bidders, right up until the
13 final moment. They went so far as to completely negotiate purchase agreements
14 with two separate bidders and, in this way, were able to generate pressure on each
15 bidder continually to make additional concessions. Further, they were able to give
16 the Qwest board two sale options up to the very last day of the four-month process.
17 The psychological impact of this strategy was profound. During significant periods
18 of time, often at seemingly crucial junctures, the Qwest negotiating team would
19 simply vanish, leading us to conclude that they had decided to pursue negotiations
20 with other bidders. During those times, it was easy to conclude that we needed to
21 improve our offer in order to get “back in the game,” so to speak.
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1 Q. IN A COMPETITIVE AUCTION, BIDS SOMETIMES ESCALATE OVER TIME,
2 BUT THAT DIDN'T HAPPEN HERE. WHY DID YOUR OFFERED PRICE
3 DECLINE BETWEEN YOUR INITIAL BID AND THE FINAL, SUCCESSFUL
4 OFFER?
5 A. First, let me clarify one aspect of your question. This was not what one thinks of as
6 a typical "auction" where bidders compete with perfect knowledge of the other
7 bidders' offers and actions. Here, we were highly reliant on Qwest to tell us when
8 our offer was satisfactory, when it was not, and when other bidders had made a
9 superior offer. As a result, Qwest was able to magnify the amount of competition we
10 perceived, and I suspect that they acted similarly with respect to the other bidders.
11 Throughout the four-month bidding process, we consistently bid using a
12 multiple of approximately 8.0x EBITDA. Our eventual purchase price was lower
13 than both our initial non-binding offer and what I now know to be the upper ranges
14 of the preliminary estimates of Qwest's financial advisors, primarily because our
15 estimates of 2002 and future Dex EBITDA declined between the time we made our
16 initial offer in May and the time that the purchase agreement was signed in August.
17 In our initial bid, because of time constraints, we had to rely on the Dex management
18 team's estimate of 2002 EBITDA as it existed in May, 2002. I believe that Qwest's
19 financial advisors used these EBITDA projections (or other similar and
20 contemporaneous ones) as the foundation for their original estimates as well.
21 By the time of our second-round bid, in July, 2002, we had completed the
22 first phase of our due diligence review of Dex, and had concluded that EBITDA for
23 2002 and into the future would be lower than originally expected, leading us
24 commensurately to reduce our proposed purchase price. The primary driver of lower
25 EBITDA was additional expense that we believed Dex would incur once the
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business was separated from Qwest. As a standalone entity, we expect that some of Dex's expenses will increase over the levels that Dex has historically experienced as a Qwest affiliate. These expenses generally fell into three categories:

(A) Additional expense that Dex would incur as a stand alone company for administrative and IT functions. For example, Qwest historically had allocated expenses to Dex for information technology, finance, real estate and human resources functions, among others, that it performed on Dex's behalf. As a stand-alone business, Dex would need to build these capabilities internally and we estimated that Dex would incur additional cost in order to do so.

(B) Additional expenses that Dex would incur as a result of losing purchasing economies of scale by being part of a much larger Qwest organization. A good example of this is health benefits. As a smaller company, we believe that Dex's benefits expense would be higher than it is under Qwest since it no longer will enjoy the purchasing economies of scale that Qwest does.

(C) Reversal of income items that we considered non-recurring. The most notable example of this adjustment was the reversal of pension credits (which resulted in income on Dex's financial statements) that Dex had benefited from historically, but we did not expect to realize going forward.

Even putting aside these standalone costs, it had become clear by the summer of 2002 that Dex was going to miss Qwest's earlier estimates of 2002 EBITDA as a result of some softness in demand for directory advertising. This caused us further to revise our EBITDA projections.

Moreover, after we had submitted our second-round bid, Qwest changed its accounting methodology used for Dex from the Point-of-Publication method to the more conservative Deferral and Amortization method of accounting. This restatement lowered historical EBITDA levels. Although this accounting change did not affect actual cash flows, it did affect our ability to obtain debt financing for the transaction. In determining acceptable levels of leverage for a transaction of this type, banks look to historical metrics, such as EBITDA. Just as a home mortgage lender's interest rates increase when the homebuyer decides to make a relatively small down payment (increasing the leverage of the home sale), banks are reluctant to provide debt financing above certain levels that are determined, in part, based on historical EBITDA.

Q. DR. SELWYN SUGGESTS THAT THE INVESTIGATION BY THE SECURITIES AND EXCHANGE COMMISSION INTO QWEST'S ACCOUNTING AND FINANCIAL REPORTING PRACTICES ARTIFICIALLY DEPRESSED THE BIDS FOR DEX. (SELWYN AT 23-24.) YOU JUST MENTIONED THAT AN ACCOUNTING CHANGE CAUSED YOU TO REDUCE YOUR BID. IS THAT TO SAY THAT DR. SELWYN IS CORRECT?

A. No, not at all. This accounting change had no impact on the actual performance of the Dex business, which is ultimately the most significant factor determining our offer price. The point-of-publication accounting method accelerates the recognition of directory advertising revenues by recognizing this revenue at the time the first directory is delivered. In contrast, deferral and amortization accounting recognizes this revenue gradually over the overall life of the directory. When Qwest returned to its historical practice of using deferral and amortization accounting for the Dex business during the summer of 2002, we were able to gain a clearer picture of the

1 Dex revenue stream. This meant that we had different, lower EBITDA numbers on
2 which to base our bid for Dex, but it did not affect the EBITDA multiple we used to
3 bid, or otherwise cause us to reduce our offer price.

4 Q. DID YOU PLAY AN ACTIVE ROLE IN DETERMINING THE MARKET
5 VALUE OF THE DEX BUSINESS FROM THE PERSPECTIVE OF THE
6 BUYER?

7 A. Yes, I did. I was an active participant in our ongoing evaluation of the value of Dex.

8 Q. AS A RESULT OF THIS PARTICIPATION, DO YOU CONCUR WITH THE
9 CONCLUSION OF MR. BROSCH, DR. SELWYN, AND DR. BLACKMON
10 THAT THE MAJORITY OF THE VALUE QWEST IS CONVEYING IS
11 CONTAINED IN THE DIRECTORY PUBLISHING AGREEMENT AND THE
12 NON-COMPETITION AGREEMENT, EXHIBITS D AND M TO THE RODNEY
13 PURCHASE AGREEMENT, RESPECTIVELY?

14 A. No, I do not. While the Publishing Agreement and the Non-compete Agreement
15 unquestionably have value, they do not constitute anything close to the majority of
16 the value of the Dex transaction. Far more valuable are the employees of Dex, who
17 have built customer relationships over the years with local and national advertisers,
18 and who maintain those relationships on a day-to-day basis, as well as general "know
19 how" on how to run a directory business. These relationships require constant
20 tending and replenishment and, together with the familiar DEX and QWEST DEX
21 trademarks, constitute the majority of the value of Dex. As I stated in my direct
22 testimony, the value of the Dex employees and their relationship with the Dex
23 customer base simply cannot be overstated.

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Q. WHAT ABOUT THE EXPANDED USE LIST LICENSE AGREEMENT, EXHIBIT F TO THE RODNEY PURCHASE AGREEMENT? DO YOU AGREE WITH DR. SELWYN'S CHARACTERIZATION OF THAT AGREEMENT AS ONE OF THE "ITEMS CONVEYING THE MOST VALUE?"

A. No, I do not. While useful, the Expanded Use List License Agreement is neither central to the Dex business nor even exclusive to Dex. My understanding of the agreement is that any other directory publisher would be entitled to a similar arrangement. Indeed, especially after completing the sale of Dex, there would seem to be little reason for Qwest to refuse to enter into such an Expanded Use List License Agreement with any directory publisher that wanted one.

Q. DR. SELWYN EXPLAINS THAT, UNDER FAS 141, THE COMPANY MUST "ACCOUNT FOR IDENTIFIABLE INTANGIBLE ASSETS AND GOODWILL." (SELWYN AT 77.) TO DATE, HAS DEX HOLDINGS COMPLIED WITH FAS 141?

A. Yes, it has. For financial reporting, accounting, and taxation purposes, FAS[1] 141 generally requires all business combinations to be accounted for using the "purchase method," eliminating the "pooling of interests" option formerly available. In addition, FAS 141 requires the company to recognize intangible assets that meet certain criteria separately from goodwill. Finally, FAS 141 requires the allocation of the purchase price paid to the assets acquired and liabilities assumed by major balance sheet category.

Immediately following the closing of the Dex Media East, or "Dexter," portion of the transaction, Dex Holdings hired Murray Devine & Co., a valuation firm specializing in financial opinions, business enterprise, and securities valuations,

[1] "Financial Accounting Standard" as adopted by the Financial Accounting Standards Board or "FASB."

to prepare a FAS 141 analysis of that transaction to assist Dex Media East, Inc. in complying with FAS 141. Murray Devine finalized this analysis on March 11, 2003, after conducting an investigation and valuation of the assets that Dex Media East, Inc. acquired at the first closing on November 8, 2002. I have attached the FAS 141 analysis prepared for Dex Media East, Inc. to this testimony as Highly Confidential Exhibit WEK-3HC.

Q. WHAT IS THE PURPOSE OF A FAS 141 ANALYSIS?

A. Dex Media East will use this analysis to comply with IRS and FASB standards for financial reporting, accounting, and taxation purposes. In the course of any acquisition of this type, a FAS 141 analysis must be prepared.

Q. WHAT DOES THE FAS 141 ANALYSIS SHOW FOR DEX MEDIA EAST, INC.?

A. For financial reporting, accounting, and taxation purposes, Dex Media East, Inc. values the non-competition and publishing agreements **[Begin Highly Confidential>** *** *********<**End Highly Confidential]** percent of the transaction value. Applied to the Dex Media West transaction, this ratio would value the non-competition and publishing agreements at roughly **[Begin Highly Confidential>********** <**End Highly Confidential]** in the Rodney region. In contrast, the FAS 141 report values the Dex Media East employee relationships with national and local advertisers at nearly**[Begin Highly Confidential>** *********<**End Highly Confidential]**

Q. WAS THE MURRAY DEVINE APPRAISAL PREPARED IN ANY PART TO REBUT THE CLAIMS OF STAFF AND PUBLIC COUNSEL?

A. No, not at all. It was prepared in the ordinary course of business to comply with tax regulations and financial accounting standards. Indeed, the final report was issued a

1 week before staff and Public Counsel filed their testimony. Murray Devine were not
2 even aware that their appraisal might be used in this docket until we notified them of
3 its possible use in the first half of April, almost a month after they completed their
4 work.

5 **III. COMPETITION IN THE DIRECTORY PUBLISHING INDUSTRY**

6 Q. IN THEIR TESTIMONY, DR. SELWYN AND DR. BLACKMON DISPUTE
7 YOUR CONCLUSION THAT "MARKET TRENDS DO SUGGEST . . . THAT
8 THE YELLOW PAGES BUSINESS WILL BECOME INCREASINGLY
9 COMPETITIVE, MAKING THAT BUSINESS MORE DIFFICULT TO OPERATE
10 AS A DIVISION OF AN ILEC." (KENNARD AT 10.) IN PARTICULAR, DR.
11 BLACKMON STATES THAT, "IT SHOULD BE OBVIOUS THAT THE BUYER
12 DOES NOT BELIEVE THIS IS REALISTIC." (BLACKMON AT 8.) HOW DO
13 YOU RESPOND?

14 A. Dr. Blackmon has entirely misunderstood and mischaracterized my testimony. Dr.
15 Blackmon erroneously attributes testimony to me that the directory business will
16 decline in value. To clarify my testimony on that point, I believe that it is impossible
17 to say with any degree of certainty what the future holds for Dex, or whether the
18 business will decline in value. Clearly, as a representative of the buyer, I hope that it
19 does not.

20 A combination of regulatory, market, and technological changes, however,
21 have dramatically increased the uncertainty and risk associated with the directory
22 publishing business. For example, Verizon recently announced its intention to
23 publish competing directories in certain Qwest exchanges. In the regulatory arena,
24 among other changes, as Chairman of the Federal Communications Commission I
25 led the agency in issuing rules mandating nondiscriminatory access to subscriber list
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information for all directory publishers, including those seeking to publish Internet-based directories. Technologically, competitors are increasingly using this listing information as the basis for competing printed directories, Internet-based directories, CD-ROM directories, wireless and wireline voice-portal directories, and others. In the not-too-distant future, wi-fi-enabled devices, wide area broadband, and 3G wireless technology, just to name a few possibilities, may challenge the primacy of printed directories. Market changes are closely tied into these technological advances, as customers demand access to directory listings and related information in new formats over a host of new platforms.

What these changes portend for the directory publishing business is not entirely clear. What is certain, however, is that Dex can no longer think of itself as a printed directory publisher. Murray Devine points out in the FAS 141 analysis prepared for Dex Media East that printed directories compete today for advertising dollars against **[Begin Highly Confidential>** ******************************
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********<End Highly Confidential]** (Exhibit WEK-3HC at 4.) Most strikingly, Murray Devine also states that, **[Begin Highly Confidential>** ****************
***<End Highly Confidential]**

Indeed, the May, 2002, "Dex Management Presentation," Qwest Response to Public Counsel Data Request No. ATG 01-012 shows **[Begin Confidential>********
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***<End Confidential]**
That presentation also describes the **[Begin Confidential>** ********************
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*****************<**End Confidential]** Needless to say, it represents a significant challenge to **[Begin Confidential>** ************************************
******<**End Confidential]** and the level of success that Dex will enjoy is far from certain.

Q. DR. SELWYN, CITING DEX'S CONTINUED REVENUE GROWTH OVER THE PAST TWO DECADES, CONTENDS THAT IT IS "OVERLY SIMPLISTIC" TO EXPECT DIRECTORY PUBLISHING COMPETITION TO INCREASE OR PLACE ADDITIONAL PRESSURE ON DIRECTORY ADVERTISING REVENUES. (SELWYN AT 49.) HOW DO YOU RESPOND?

A. It should be evident by now that I strongly disagree. The changes I described above will unquestionably place additional pressure on Dex revenues. Already, Dex's recent history is one of **[Begin Confidential>** *************************
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*******<**End Confidential]** Industry research indicates that, overall, the directory industry grew only 1 percent during 2002, and directory operations affiliated with incumbent local exchange carriers declined in the aggregate.

So far, the revenue impact of these reductions has been offset by advertising rate increases for those customers that remain. Even so, although Dex revenues bucked the industry's decline in 2002, its growth numbers were still far below historical trends. A strategy of increasing rates cannot succeed forever. Already, as Dr. Selwyn points out, Qwest's Advertising Defector Tracking Study (Selwyn Exhibit LLS-22HC), the leading reasons why advertisers decide to discontinue advertising in the Dex printed directories [**Begin Confidential>** **************
****

< **End Confidential]

As Dr. Selwyn notes, the top two reasons that customers stop advertising with Dex are **[Begin Confidential>** ** *** *****< **End Confidential]** (Selwyn at 94.)

Q. WHY WOULD CARLYLE AND WCAS PAY OVER $7 BILLION FOR SUCH A RISKY BUSINESS?

A. As I said earlier, the Dex business is fundamentally sound, but it faces significant challenges in the upcoming years. If Dex rises to those challenges, it can continue to enjoy the type of growth and market success it historically has shown. If it does not, it will be trapped in a declining segment of the advertising industry. It seems to me that the testimony of Drs. Selwyn and Blackmon simply proceeds from an overly-optimistic outlook on the future of the directory publishing industry. They contend that our purchase price for Dex is too low, and that the risk we perceive in the industry is largely nonexistent. We at Carlyle and WCAS do not have the luxury of viewing the industry through such rose-colored glasses. As investors, we cannot afford to believe on blind faith that the printed yellow pages directory market will inexorably continue the upward trajectory it has traced for the past twenty years. We have to back up our bets on the future with real money, and so must take a more realistic view of the market and what the future might hold. The EBITDA multiple reflected in the competing bids and the ultimate purchase price reflects the market's assessment of the level of risk prevailing today in the directory publishing market.

Q. SO WHAT DOES THIS MEAN FOR LOCAL RATEPAYERS?

A. Simply put, it means that the Commission should support Qwest's decision to sell Dex at this point in time. Directory revenues may not continue to increase at

historical rates, and may suffer periods of decline. Dex no longer can be viewed as a proverbial goose that will lay an ever-increasing number of golden eggs. It will take a great deal of innovation, investment of resources, and creativity to maintain Dex's market position, with no certainty of success. With rising uncertainty in the directory publishing industry, this is a reasonable time for Qwest to realize the gain from the increase in Dex's value since 1984.

IV. THE ROLE OF THE REGULATOR IN REVIEWING THIS TRANSACTION

Q. HOW DO YOU REACT TO DR. SELWYN'S AND DR. BLACKMON'S RECOMMENDATIONS THAT THE COMMISSION BLOCK THE DEX SALE?

A. It would not serve the public interest to block the Dex sale. Qwest is in the best position to offer testimony on the likely impact that bankruptcy could have on the ratepayers, QC, and its affiliates, and I understand that QC will be submitting such testimony. It seems clear from Qwest's testimony that blocking the sale would heighten the risk of bankruptcy for QCI. Bankruptcy for QCI would, in turn, heighten the risk that QC and Qwest Dex would be sold under the supervision of the bankruptcy court, perhaps separately. No matter how the Commission assesses the likelihood that these two assets would remain under common ownership, and no matter how the Commission assesses the likelihood that QC, post-bankruptcy, could win a lucrative publishing contract from the eventual owners of Dex, it seems certain that such a course creates dramatically heightened risk that the ratepayer could come away empty-handed. The public interest would be far better served if the Commission were to approve the Dex sale, subject to suitable conditions that address ratepayer needs in this proceeding. The Commission is likely to have far less control over the process, with correspondingly less ability to safeguard ratepayer interests, in a proceeding before a bankruptcy court.

1 **V. CONCLUSION**

2 Q. COULD YOU PLEASE SUM UP YOUR TESTIMONY TODAY

3 A. Certainly. First, I believe that QCI conducted a robust, competitive auction of the
4 Dex directory publishing business and extracted the full market value of that
5 business asset as a result of that auction. In no way can the sale process accurately
6 be characterized as non-competitive. Moreover, QCI's financial difficulties,
7 although widely known, had no impact on the price that resulted from the
8 competitive auction process. Finally, in no way is the majority of the value of the
9 transaction contained in the new non-competition and publishing agreements.

10 Second, the directory publishing business is characterized by increasing risk.
11 That is not to say that Dex necessarily will become less valuable or less profitable in
12 the future. It does mean, however, that the business will have to evolve in creative,
13 new ways to maintain its market position, and that this evolution will require the
14 commitment of considerable resources that are likely to impact the profitability of
15 Dex. Further, it means that the risk of failure is higher now than it has been,
16 probably at any time during the last 80 years.

17 Third, and finally, in light of these risks, I believe that it would disserve the
18 public interest for the Commission to withhold its approval of the Dex sale. Whether
19 or not the Commission believes that it is likely that such action would cause QCI to
20 enter bankruptcy, that such a bankruptcy would precipitate the sale of QC or Dex,
21 that QC and Dex would be sold to the same purchaser, and, if not, that QC could
22 extract a lucrative publishing deal from the eventual owners of Dex, it seems plain
23 that the risk that ratepayers could be forced to walk away empty-handed at any step
24 in that chain is considerably higher than it is in this proceeding. Therefore, the
25 Commission should take this opportunity to approve the Dex sale, subject to
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1 reasonable conditions that protect the public interest while permitting the sale to go
2 forward.
3 Q. DOES THIS CONCLUDE YOUR TESTIMONY?
4 A. Yes, it does. Thank you.
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