EXHIBIT PCC-7RT

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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

REBUTTAL TESTIMONY

OF

PETER C. CUMMINGS

QWEST CORPORATION

APRIL 17, 2003

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1 **I. IDENTIFICATION OF WITNESS**

2 **Q. PLEASE STATE YOUR NAME, ADDRESS AND EMPLOYMENT.**

3 A. My name is Peter C. Cummings and my business address is 1600 Bell Plaza,
4 Room 3005, Seattle, Washington, 98191. I am employed by Qwest Corporation
5 as Director - Finance.

6 **Q. DID YOU FILE DIRECT TESTIMONY IN THIS PROCEEDING?**

7 A. Yes.

8 **Q. ARE YOU ADOPTING THE DIRECT TESTIMONY OF ANY OTHER**
9 **WITNESS IN THIS PROCEEDING?**

10 A. Yes. I am adopting the direct testimony of Brian G. Johnson as filed with the
11 Commission on January 17, 2003.

12 **II. PURPOSE OF TESTIMONY**

13 **Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?**

14 A. The purpose of my testimony is to provide rebuttal to certain portions of the direct
15 testimony filed by WUTC staff witnesses, Dr. Glenn Blackmon, Ms. Kathleen M.
16 Folsom, and Dr. Lee L. Selwyn.

17 **Q. WHAT ISSUES WILL YOU ADDRESS IN YOUR TESTIMONY?**

18 A. My testimony addresses the following issues:

19 Section III: I respond to Dr. Blackmon's assertions that the risk of bankruptcy is
20 not a valid reason for the Commission to approve the Dex sale and that Qwest

1 Corporation (QC) might be better off with Qwest Communications International
2 Inc. (QCI) in bankruptcy. I present financial and operational data for Qwest
3 Corporation and Portland General Electric (PGE) and demonstrate that, contrary
4 to Ms. Folsom's conclusions, the effect of a QCI bankruptcy on QC is likely to be
5 quite different than her observed effects of the Enron bankruptcy on PGE.

6 Section IV: I discuss the long term financial effects of the Dex sale. The sale of
7 Dex is the keystone of QCI's business plan to delever the consolidated balance
8 sheet and restore the financial health of the company.

9 Section V: I demonstrate that, contrary to Dr. Selwyn's assertions, the need to
10 sell Dex does not mean that less than full value was obtained from the transaction.
11 The agreement to sell Dex was an arms-length, fair market transaction. Clearly,
12 as I explained in my direct testimony, QCI needs to sell Dex, but an examination
13 of the bidding process and capital market conditions leads to the conclusion that
14 QCI received full value for the Dex sale.

15 Section VI: I address Staff's recommended conditions for Commission approval
16 of the Dex sale. Staff's recommendation contains provisions which: (1)
17 misinterpret the Material Regulatory Impact (MRI) provisions of the Dex sales
18 agreement; (2) require Commission imposition of regulations which are not
19 related to the Dex sale; and (3) are of questionable public policy benefit.

1 2 **III. BANKRUPTCY ISSUES RAISED BY STAFF WITNESSES BLACKMON AND FOLSOM**

3 **Q. DR. BLACKMON FINDS QWEST'S STATEMENTS ABOUT**
4 **POTENTIAL BANKRUPTCY TO BE INCONSISTENT BETWEEN ITS**
5 **COMMUNICATION WITH THE FINANCIAL COMMUNITY AND ITS**
6 **COMMUNICATION WITH THE REGULATORY COMMUNITY. DO**
7 **YOU BELIEVE QWEST'S STATEMENTS ARE INCONSISTENT?**
8 A. No. To support his contention, Dr. Blackmon cites recent financial conference
9 comments by Qwest's CFO where "bankruptcy" was never mentioned and
10 remarks last fall by Qwest's CEO that the company was not considering
11 bankruptcy. QCI's messages to the financial community are not inconsistent with
12 the advocacy presented to the Washington Commission. The statements to the
13 financial community referenced by Dr. Blackmon describe the financial condition
14 of QCI based on the assumption that the second phase of the Dex sale closes. As
15 described in my direct testimony, QCI's agreement to sell Dex was critical to
16 successful negotiation of the amended and revised credit agreement (ARCA) and,
17 absent the ARCA, Qwest would almost certainly have been facing bankruptcy
18 given the payment obligations and debt covenants in the previous credit
19 agreement.

20 Bankruptcy isn't being discussed with the financial community because, with the
21 Dex sale, QCI has a business and financial plan for financial restructuring which
22 does not depend upon formal reorganization through the bankruptcy court. The
23 key element of that business and financial plan is the Dex sale.

1 **Q. JUST TO BE CLEAR, DOES QWEST INTEND TO FILE BANKRUPTCY**
2 **AT THIS TIME?**
3 A. No.

4 **Q. PLEASE RESPOND TO DR. BLACKMON'S STATEMENT THAT "QC**
5 **MIGHT BE BETTER OFF WITH ITS PARENT IN BANKRUPTCY."**
6 A. Dr. Blackmon's contention that QC might be better off with its parent in
7 bankruptcy is speculative. Mr. Mabey's testimony discusses the uncertainty
8 associated with bankruptcy. A QCI bankruptcy filing might, or might not,
9 involve a change of ownership for QC and we simply have no way of knowing
10 the identity and perspective of such new ownership. As Mr. Mabey explains, in a
11 bankruptcy, the Commission would also likely lose control over a sale of QC.
12 This adds to the speculative nature of Dr. Blackmon's rather dramatic position. I
13 believe the long term perspective is best nurtured and preserved by actions to
14 solve the company's financial problems, to avoid bankruptcy, and to provide
15 profitable long term growth opportunities.

16 **Q. DO YOU BELIEVE ANY STAKEHOLDERS WOULD BE BETTER OFF**
17 **WITH QCI IN BANKRUPTCY?**
18 A. No. My analysis of the issues involved leads to the conclusion that none of the
19 stakeholders involved would be "better off" with QCI in bankruptcy.

20 • Qwest shareholders (including pension funds, other institutional
21 investors, employees, and individual investors) would likely lose their
22 entire investment.

1 • Customers would likely lack access to new and improved services from
2 a company operating under bankruptcy protection.

3 • Employees and retirees would be at risk for reductions in health care
4 and some pension benefits under any QCI bankruptcy scenario.

5 • Investors would be worse off under bankruptcy. Stockholders would
6 likely lose their entire investment and bondholders would likely not
7 recover their full investment.

8 • Suppliers and vendors of goods and services purchased by Qwest would
9 likely experience decreased sales and the increased risks associated with
10 being general unsecured creditors.

11 • Competitors might gain market share following a Qwest bankruptcy, but
12 interconnection with Qwest facilities could be complicated by bankruptcy
13 administration.

14 These issues and others are detailed in the rebuttal testimony of bankruptcy
15 practitioner and expert, Ralph R. Mabey.

16 **Q. MS. FOLSOM TESTIFIES THAT "PGE [PORTLAND GENERAL**
17 **ELECTRIC] APPEARS TO BE IN BETTER SHAPE THAN QC TODAY**
18 **EVEN THOUGH PGE'S PARENT IS IN BANKRUPTCY AND QC'S**
19 **PARENT, QCI IS MERELY AT RISK OF BANKRUPTCY." IS PGE IN**
20 **BETTER SHAPE NOW THAN IT WAS BEFORE THE ENRON**
21 **BANKRUPTCY?**

1 A. No. Despite Enron and PGE actions to create a "ring fence"[1] structure around
2 PGE to preserve its value as an entity held for sale and strong intervention by the
3 Oregon Public Utility Commission (the single state entity regulating PGE), the
4 company is, in fact, in worse financial shape than before the Enron bankruptcy.
5 Exhibit PCC-8 shows PGE's bond ratings before the merger with Enron and as
6 they are today. Ratings by Standard & Poor's and Moody's declined from the
7 low single "A" range before the merger to the mid to low "BBB" range currently.
8 Fitch Investors Service did not rate PGE before the merger but now rates the
9 company at the non-investment grade rating of "BB-."

10 In addition, PGE stated in its most recent 10K that the company's ability to access
11 the commercial paper market has been adversely affected by the May 2002 ratings
12 reduction for commercial paper by Moody's and Fitch. While Ms. Folsom is
13 correct that PGE does currently have higher bond ratings than QC, it does not
14 follow that this difference somehow proves that QC would be better off with QCI
15 in bankruptcy. The facts are that PGE's financial risk increased significantly after
16 the merger with Enron and the subsequent bankruptcy of its parent company.

17 **Q. ARE THERE OTHER POTENTIAL EFFECTS OF THE ENRON**
18 **BANKRUPTCY ON PGE THAT MS. FOLSOM DOES NOT ADDRESS IN**
19 **HER TESTIMONY?**

20 A. Yes. Enron's bankruptcy may continue to have an adverse affect on PGE's credit
21 ratings and access to capital markets. In its most recent 10K filing, PGE states
22 that, "due to continuing uncertainty regarding the impact of Enron's bankruptcy

[1] Mr. Mabey defines and discusses the concept of a "ring fence" in his rebuttal testimony.

1 on PGE, management is unable to predict what actions, if any, will be taken by
2 the rating agencies in the future."

3 PGE further noted in the 10K that, "Although PGE is not included in the Enron
4 bankruptcy, it has been affected." PGE disclosed effects of the Enron bankruptcy
5 as follows:

6 - PGE was included among those Enron subsidiaries suspended from
7 contracting with the federal government.

8 - PGE may have potential exposure to certain liabilities and asset
9 impairments as a result of Enron's bankruptcy.

10 - Enron could direct that the PGE pension plan be merged with the Enron
11 plan, thus reducing the deficiency in Enron's plan with the excess assets in
12 PGE's plan. Enron could also terminate its pension plan under certain
13 conditions and, if Enron terminated an underfunded plan, all members of
14 Enron's controlled group (including PGE) would become jointly and
15 severally liable for the underfunding.

16 - Under income tax regulations issued by the U.S. Treasury Department,
17 each member of a consolidated group is severally liable for the tax liability
18 of the consolidated group. If the IRS sought payment from Enron and
19 Enron did not pay, the IRS could look to PGE and other members of the
20 consolidated group for payment.

1 **Q. MS. FOLSOM'S TESTIMONY POSITS THAT THE EXPERIENCE OF**
2 **PGE RELATIVE TO THE ENRON BANKRUPTCY SUGGESTS TO THE**
3 **COMMISSION THAT THE CIRCUMSTANCES OF QC AND ITS**
4 **CUSTOMERS WOULD BE IMPROVED BY A QCI BANKRUPTCY**
5 **FILING. DO YOU AGREE WITH HER CONCLUSION?**
6 A. Absolutely not. PGE's situation is very different from QC's situation. PGE is
7 quite small relative to Enron and is a small operation relative to QC. QC has
8 always been closely integrated with its parent company and is the dominant
9 subsidiary of the consolidated operations of QCI. PGE is a recent acquisition by
10 Enron and is neither well integrated nor dominant in consolidated operations, and
11 had been up for sale prior to Enron's bankruptcy filing.

12 Exhibit PCC-8 compares the scope of PGE to QC and shows the relative
13 importance of PGE to Enron and the importance of QC to QCI. PGE is a small
14 company with less than one million customers in a service territory limited to a
15 portion of a single state – Oregon. QC serves twenty-five million customers in a
16 14-state territory. On the basis of company scope alone, Ms. Folsom's
17 comparison of QC to PGE and her conclusion that QC would be better off with
18 QCI in bankruptcy is inappropriate.

19 The larger difference between PGE and QC is their degree of importance to the
20 parent company and consolidated operations. PGE comprises about 2% of the
21 revenues, and 5% of the assets of Enron. PGE is clearly not a major asset to be
22 dealt with in the financial restructuring of the bankruptcy process. It is a small

1 asset with little or no potential for further subdivision and is currently held for
2 sale.

3 QC is very important to QCI. QC is QCI's major asset, comprising more than
4 70% of property, plant and equipment and providing 74% of consolidated
5 revenues. As Mr. Mabey discusses in his rebuttal testimony, a QCI bankruptcy
6 could, for a number of reasons, lead to or include a QC bankruptcy filing.
7 Because of the dominant, integrated position of QC in the consolidated structure
8 of QCI, I believe a QCI bankruptcy would, at the very least, significantly impact
9 QC. Stated another way, should QCI and QSC be forced to declare bankruptcy,
10 the stock of QC would be the primary asset falling under the jurisdiction of the
11 bankruptcy court. This is a far different situation than that facing PGE in the
12 Enron bankruptcy. I recommend that the Commission read carefully the expert
13 testimony of Mr. Mabey and not place any reliance upon the PGE analogy
14 presented by Ms. Folsom or on her conclusion that a QCI bankruptcy filing may
15 actually improve circumstances for QC and its customers.

16 **IV. LONG TERM FINANCIAL EFFECTS OF DEX SALE**

17 **Q. DR. BLACKMON ARGUES THAT THE LONG TERM EFFECT OF THE**
18 **DEX SALE TRANSACTION WILL BE TO INCREASE THE FINANCIAL**
19 **RISK OF QCI AND THAT THAT RISK SHOULD NOT BE ABSORBED**
20 **BY QC OR ITS CUSTOMERS. CAN YOU PROVIDE EVIDENCE ON**
21 **THE LONG TERM FINANCIAL RISKS?**
22 A. Yes. For the longer term, the Dex sale provides the foundation for other elements
23 of QCI's financial plan which include debt exchanges, cash flow initiatives, re-

1 negotiation of long term contracts, and other asset sales. In plain terms, without
2 the sale of Dex in the near term, there is no long term for QCI. With the sale of
3 Dex in the near term, Qwest's business plan can be successfully implemented
4 with the result of positive impact on long term financial health.

5 Contrary to Dr. Blackmon's argument, evidence from the capital markets
6 indicates that long term financial risk for QCI and QC has declined since the Dex
7 sale announcement. The capital market reaction to the announcement of the Dex
8 sale and completion of the first phase (Dexter) has been positive for the company,
9 resulting in lower financial risk and capital costs. Since the announcement of the
10 sale of Dex and the completion of the first phase of the sale, QCI has seen an
11 increase in the price for its stock and a decrease in the investor-required bond
12 yield for QC bonds. These changes reflect lower financial risk for both stock and
13 bond investors.

14 Exhibit PCC-2 to my direct testimony shows the daily stock prices for QCI.
15 Higher stock prices equate to lower financial risk and capital costs. A share of
16 stock sold to the public for $10 is worth more to a company than a share of stock
17 sold at $9. During the month before the August 20, 2002 announcement of the
18 Dex sale, QCI stock traded at prices under $2.00 per share. Since that date, QCI
19 stock price has steadily increased, generally trading near or above $4.00 per share
20 since the November 8, 2002 Dexter sale close, ending the year 2002 at $5.00 per
21 share, and trading in the $3.50 to $4.00 range in 2003.

1 Exhibit PCC-9 shows third and fourth quarter 2002, and first quarter 2003
2 estimates of QC's borrowing costs – the estimated costs of issuing new debt
3 securities. Over the time period spanning the announcement of the Dex sale
4 transaction and the Dexter sale close, QC's bond ratings have not changed and
5 U.S. Treasury benchmark interest rate yields have been nearly constant. The
6 credit spreads for QC have declined significantly during this same time period,
7 indicating lower financial risk and lower borrowing costs for QC. The following
8 extract from Exhibit PCC-9 shows the decrease in credit spreads and thus
9 borrowing costs for typical long term financing.

10 QC Credit Spreads 3Q 2002 to 1Q 2003

11 Term	3Q 2002	4Q 2002	1Q 2003	Change 3Q to 1Q
12 10 yr.	7.542%	5.635%	4.054%	Down 3.488%
13 30 yr	5.820%	4.522%	3.535%	Down 2.285%

14 **Q. WHAT IS THE SIGNIFICANCE OF THE DECREASE IN QC CREDIT**
15 **SPREADS?**
16 A. The lower credit spreads translate directly into lower borrowing costs for QC.
17 The investor reaction to announcement of the Dex sale, actual close of the first
18 phase of the sale, and other aspects of Qwest's financial restructuring plans has
19 been to lower the cost of new 10-year debt by about 3.5% and new 30-year debt
20 by about 2.3%.

21 **Q. WHAT DOES THIS TELL US ABOUT INVESTOR EXPECTATIONS**
22 **FOR FINANCIAL RISK IN THE LONG TERM?**

1 A. The credit spreads reflect investor long term expectations and the decline in credit
2 spreads indicates that investors expect lower long term financial risk for QC as a
3 result of the Dex sale.

4 **V. VALUATION OF THE DEX SALE**

5 **Q. DR. SELWYN CITES YOUR DIRECT TESTIMONY (AND THAT OF**
6 **MR. JOHNSON, WHICH YOU HAVE ADOPTED) IN SUPPORT OF HIS**
7 **DESCRIPTION OF THE SALE OF DEX AS A "DISTRESS SALE." DO**
8 **YOU AGREE WITH THE TERM "DISTRESS SALE"?**
9 A. No. I described the Dex sale as "necessary," "critical," and "the key component
10 in QCI's business plan to stabilize its financial position." The Johnson testimony
11 characterizes the Dex sale as "the most promising and appropriate strategy for
12 raising necessary cash on a short timeline," and "a critical component of QCI's
13 financial viability over the next few years." The difference between these
14 descriptions of the Dex sale and Dr. Selwyn's term "distress sale" is in one sense
15 a matter of semantics – we all agree on the necessity to sell Dex.

16 In the larger sense, Dr. Selwyn's term "distress sale" forms the basis for his
17 conclusion that QCI did not receive a fair price or full value for Dex. I disagree
18 with Dr. Selwyn's conclusion. The Dex sale was a fair market transaction
19 reflecting the full value of the Dex business. The sale process engaged multiple
20 competitive bidders in the largest leveraged buyout since the buyout of RJR
21 Nabisco during the late 1980's.

1 **Q. DID QCI'S FINANCIAL ADVISORS RENDER AN OPINION AS TO THE**
2 **FAIRNESS OF THE DEX SALE TRANSACTION?**
3 A. Yes. QCI was informed and advised throughout the Dex sale transaction by
4 Lehman Brothers and Merrill Lynch. Both investment banks rendered opinions to
5 the QCI Board of Directors that the Dex sale transaction was fair, from a financial
6 point of view, to the company based upon the aggregate compensation to be
7 received by the company. Both firms advised that their fairness opinions were
8 "necessarily based upon market, economic, and other conditions as they exist and
9 can be evaluated."

10 **Q. IS THIS IMPORTANT?**
11 A. Yes. Market, economic, and other conditions actually did change during the
12 advertisement and negotiation periods of the Dex sale and these changes
13 significantly affected the final sales price.

14 **Q. WHAT CONDITIONS CHANGED?**
15 A. There were significant changes at Dex, and in the capital markets. The changes at
16 Dex involved a change in accounting methods for directory publication, along
17 with one time accounting adjustments which lowered projected 2002 EBITDA.
18 Valuation methods employing EBITDA multiples were thus affected by the lower
19 EBITDA projections. By mid-year 2002, it was apparent that Dex was not on
20 track to meet its sales projections for the year and would be unlikely to close the
21 revenue gap.

1 **Q. WHAT WERE THE CAPITAL MARKET CONDITIONS AT THE TIME**
2 **OF THE SALE?**
3 A. The capital markets were weak for junk bond financing, especially for a deal the
4 size of Dex. In its valuation presentation to the QCI board, Lehman Brothers
5 noted that the final sales price was at the "low end of the valuation range," citing
6 "transaction size/capacity constraints" and "unfavorable capital markets
7 environment" as two reasons why the price was low relative to initial valuations.
8 These factors are independent from Qwest's need to sell the asset.

9 As shown in Exhibit PCC-10, the credit spreads for high yield (junk bond)
10 financing rose dramatically from April 2002, when QCI announced its intention to
11 sell Dex, to the August 19, 2002 final sale transaction. In mid-April, high yield
12 bonds were priced at about 7.3% higher than comparable maturity Treasury
13 bonds. In mid-August, they were priced at more than 10.0% over Treasury bonds.
14 The mid-August credit spreads were approaching previous record highs for the
15 junk bond market and investors were avoiding new high yield issues.

16 The market for equity to fund the Dex purchase had contracted as well. The Yell
17 Group, the largest independent yellow pages publisher in the U.S., had to
18 withdraw its planned initial public offering (IPO) because there wasn't enough
19 equity capital available. This weakness in the equity market was also cited by
20 Lehman Brothers as contributing to the gap between earlier valuations of Dex and
21 the final sales price.

1 **Q. GIVEN THE CAPITAL MARKET CONDITIONS, WOULD IT HAVE**
2 **BEEN REASONABLE FOR QCI TO POSTPONE THE SALE OF DEX?**
3 A. No. As detailed in my direct testimony, the sale of Dex was critical to negotiation
4 of the Amended and Revised Credit Agreement (ARCA). Without the ARCA,
5 QCI would have been in violation of its credit facility covenants by third quarter
6 2002 and would almost certainly have lacked sufficient cash to make the $3.4
7 billion payment on the Amended Credit Facility required in May 2003.

8 **Q. IS THERE OTHER EVIDENCE THAT THE DEX SALE WAS FULLY**
9 **VALUED?**
10 A. Yes. The fact that the capital markets could not fully fund the transaction
11 indicates full valuation. The buyers were not able to obtain commitments to fully
12 fund the transaction and were compelled to negotiate a provision for Qwest to
13 provide $300 million of equity investment to the buyer, at the buyer's option.
14 This equity investment provision of the contract caused the buyer to give up value
15 and pay more than it otherwise would have, had complete funding been available.
16 For Qwest, the equity investment option granted to the buyer resulted in an
17 increase in value and a higher sales price.

18 If the Dex transaction was truly a "distressed sale" or undervalued, the buyer
19 would have been able to obtain financing commitments in excess of the sales
20 price negotiated. The capital markets are ruthlessly efficient and valuation
21 discrepancies are immediately exploited. If the Dex deal was undervalued,
22 market competition would have made more funds available than the buyer
23 needed. If the Dex deal was overvalued, market competition would divert funds

1 to other investments leaving insufficient funds to the buyer. Given the state of the
2 capital markets, I believe the buyer's difficulties obtaining funding reflects that
3 QCI obtained fair value for the Dex sale.

4 Finally, please refer to the rebuttal testimony of economist, William E. Taylor, for
5 a discussion of why the Commission can be assured that Qwest received fair
6 market value for the sale of Dex.

7 **VI. STAFF CONDITIONS FOR DEX SALE APPROVAL**

8 **Q. IN REVIEWING STAFF'S RECOMMENDED CONDITIONS FOR**
9 **COMMISSION APPROVAL OF THE DEX SALE, DID YOU FIND AN**
10 **APPARENT CONTRADICTION IN DR. BLACKMON'S TESTIMONY?**
11 A. Yes. Dr. Blackmon says that, first, the entire portion of the proceeds attributable
12 to Washington state directory operations should be paid to QC for the benefit of
13 Washington customers. Second, he says that the Commission should require that
14 QCI supplement the Washington share of the proceeds with additional funds from
15 the sale. Of course the contradiction is that one cannot have both all of the
16 proceeds from the sale and additional funds from the sale. If Staff's first
17 condition takes all the Washington proceeds, there are no additional proceeds to
18 fulfill Staff's second condition. It is unclear whether Staff intends the additional
19 proceeds to come from proceeds attributable to another state, or some other
20 undisclosed source of funds. Mr. Reynolds discusses the policy implications of
21 this "phantom" gain calculation in his rebuttal testimony. From a financial
22 standpoint, I believe that Staff's second condition (requiring the supplement of
23 Washington's share with additional funds) is incompatible with its first condition

1 for transfer of the entire Washington share of sale proceeds. In my view, this
2 incompatibility stems from a misinterpretation of the Material Regulatory Impact
3 (MRI) provision of the Dex sales agreement.

4 **Q. WHAT IS THE MATERIAL REGULATORY IMPACT PROVISION?**

5 A. The Material Regulatory Impact (MRI) is a sales contract provision described in
6 Section 5.4(b)(ii) of the Dex purchase agreement as follows:

> 7 As promptly as practicable, but not later than 15 days after the
> 8 execution of this Agreement, Buyer and Seller will file with the
> 9 respective State PUCs all applications for Approvals and Permits
> 10 identified on Section 3.4(a) of Seller's Disclosure Schedule. The
> 11 parties will thereafter prosecute the applications with all reasonable
> 12 diligence and will otherwise use commercially reasonable efforts
> 13 to obtain the grant of such Approvals and Permits as expeditiously
> 14 as practicable. Notwithstanding the foregoing, it is understood that
> 15 nothing contained in this Agreement shall require the Qwest
> 16 Parties or any of their respective Affiliates to consent to, accept or
> 17 otherwise proceed to close the Transactions in the event that such
> 18 Approvals and Permits, or any other Approvals or Permits that any
> 19 State PUC requires or purports to require in connection with or as a
> 20 condition to the Transactions, collectively or individually, are
> 21 reasonably likely to result in (directly or indirectly) a Material
> 22 Regulatory Impact on Qwest or its Affiliates. For purposes of this
> 23 Agreement, a "**Material Regulatory Impact**" is defined as an
> 24 impact in excess of the amount set forth in the confidential letter of
> 25 understanding dated August 19, 2002, where such amount reflects
> 26 the total net economic loss on Qwest or its Affiliates of any or all
> 27 of the following events insofar as they are required by or otherwise
> 28 result from the Transactions: (a) any reduction in aggregate net
> 29 revenues (calculated pursuant to subsection (iii)(A) below) of
> 30 Qwest Corporation or any of its Affiliates during the Fiscal
> 31 Measurement Period (as defined below), whether such reductions
> 32 arise from rate reductions, rate refunds, rebates, credits, one-time
> 33 payments, restrictions on the ability of Qwest to charge rates it
> 34 could have charged but for the Transactions, or any other reason
> 35 (each, a "**Regulatory Restriction**"); (b) any additional capital
> 36 investment (as calculated pursuant to subsection (iii)(B) below);
> 37 and (c) any additional regulatory charges or costs to or financial

1 impacts on Qwest or any of its Affiliates relating to matters under
2 the jurisdiction of the State PUCs.

3 The MRI is an escape clause, a sales contract provision to protect QCI from being
4 required to close the transaction in the event that regulatory commissions impose
5 economic losses beyond a certain threshold as required by or otherwise resulting
6 from the transaction. The MRI protects QCI from being bound to the sales
7 contract when the net economic benefit from the sales transaction falls below the
8 threshold level.

9 **Q. DOES DR. BLACKMON'S TESTIMONY MISINTERPRET THE MRI**
10 **PROVISION?**
11 A. Yes. The MRI is not (as Dr. Blackmon describes) "$500 million that QCI has
12 reserved for securing regulatory approvals." There is no fund, no bank account,
13 no cash investment, no accounting reserve, no "set aside." The MRI is a contract
14 provision that allows QCI the option to not close the transaction under the
15 conditions described above.

16 **Q. PLEASE COMMENT ON DR. BLACKMON'S RECOMMENDATION**
17 **THAT "IF THE COMMISSION WERE TO CONCLUDE THAT THE 'NO-**
18 **HARM' STANDARD WAS OTHERWISE SATISFIED, IT WOULD STILL**
19 **BE APPROPRIATE TO REQUIRE THAT QCI USE ITS $500 MILLION**
20 **REGULATORY SET-ASIDE TO COMPENSATE CUSTOMERS."**
21 A. I have two issues with Dr. Blackmon's recommendation. First, and most
22 importantly, there is no $500 million regulatory set-aside. As described above,
23 Dr. Blackmon has misinterpreted the MRI provision. Qwest has not, as Dr.

1 Blackmon claims, "explicitly set aside money that is available for the benefit of
2 customers."

3 Second, having constructed this fictitious $500 million "regulatory set aside," Dr.
4 Blackmon claims, "[s]ince Qwest is willing to pay this amount, refusing to accept
5 it would constitute a harm to customers." Through Dr. Blackmon's testimony,
6 Staff is attempting to advance the no-harm standard beyond any reasonable
7 interpretation. As discussed by Mr. Reynolds, the balancing of interests necessary
8 to reach a decision in this case is not as simple or one-sided as Dr. Blackmon
9 suggests. I recommend that the Commission reject Dr. Blackmon's concept of a
10 regulatory set aside.

11 **Q. DR. BLACKMON RECOMMENDS THAT THE COMMISSION IMPOSE**
12 **ADDITIONAL SAFEGUARDS TO PROTECT QC AND ITS**
13 **CUSTOMERS. ARE THESE RECOMMENDATIONS REASONABLY**
14 **RELATED TO THE DEX SALES TRANSACTION?**
15 A. No. The premise for Dr. Blackmon's recommendation for additional safeguards
16 is his erroneous conclusion that the long term effect of the Dex sales transaction
17 will be to increase the financial risk of QCI. My testimony demonstrates that
18 evidence from the capital markets indicates that investors expect the Dex sale to
19 <u>lower</u> financial risk for QCI and QC.

20 **Q. ARE DR. BLACKMON'S RECOMMENDATIONS REASONABLE ON**
21 **THEIR OWN MERITS?**

1 A. No. The first recommendation is that the Commission should prohibit QC from
2 increasing its debt-to-equity ratio above the present level. This is an interesting
3 recommendation in that, in previous rate cases before the Commission, Staff has
4 consistently argued that QC's rates should be set based on a hypothetical capital
5 structure that reflects more debt and less equity than historically contained in the
6 company's accounting records, but that is very consistent with QC's current
7 actual capital structure. Because QC has moved in reality in the direction that
8 Staff has always advocated is appropriate from a hypothetical standpoint, it is
9 puzzling why Staff now has concerns about that structure.

10 QC is a multi-state company that finances its operations on a combined basis.
11 There is no Washington debt or Washington equity on the company's books. In
12 conjunction with cost of service regulation in the State of Washington, it is
13 appropriate for staff to examine QC's capitalization of the Washington rate base
14 and make recommendations for Commission determination of cost of service
15 inputs resulting in customer rates. It is not appropriate for staff to attempt to
16 extend regulatory authority to company management of financing on a 14-state
17 basis.

18 **Q. WHAT IS THE SECOND RECOMMENDATION?**

19 A. Dr. Blackmon's second recommendation is that QC obtain Commission approval
20 before paying any dividend to its owner.

21 **Q. IS THAT A REASONABLE RECOMMENDATION?**

1 A. No. The recommendation would amount to double regulation of QC. The
2 Commission has already given QC approval to pay dividends to its owner through
3 the establishment of customer rates based on cost of service including the
4 opportunity to earn a fair rate of return. Dividends are paid from earnings which
5 are a product of the cost of service regulation. Earnings lawfully belong to the
6 shareholders or owners. The owner is free to choose to take all or any portion of
7 earnings as a dividend or to reinvest all or any portion of earnings in the business.
8 Dr. Blackmon's recommendation would add additional and unnecessary after-the-
9 fact regulation to the current regulation of telephone service in Washington.
10 Having established a fair rate of return for QC through cost of service, rate of
11 return regulation in Washington, it would be unreasonable for the Commission to
12 attempt to regulate earnings a second time.

13 This recommendation also runs far beyond the Commission's authority to regulate
14 the Company's Washington operations, and would, like the prior
15 recommendation, improperly exert regulatory authority over QC's entire 14-state
16 operations.

17 **Q. DOES THIS CONCLUDE YOUR TESTIMONY.**
18 A. Yes, it does.