EXHIBIT WET-1RT

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

WILLIAM E. TAYLOR

ON BEHALF OF

QWEST CORPORATION

NON-CONFIDENTIAL VERSION

APRIL 17, 2003

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I. EXECUTIVE SUMMARY

1. Valuation

First, contrary to Dr. Selwyn's assertion, the realized sales price for Dex falls well within the range of estimates of the fair market value for Dex. The process of the Dex sale ensures that the realized price reflects the maximum willingness to pay of all potential buyers in the market. There is no economic support for the notion that the difference between the realized price and the average of some set of estimated prices represents a penalty to the owner for selling at a particular time or under particular circumstances. Moreover, in Dr. Selwyn's world, stockholders cannot be required to forfeit this difference because, among other reasons, they had no prospect of gain if the sales price exceeded the average of some set of estimated prices. Indeed, if ratepayers are to be protected from loss from the sale of an asset under adverse circumstances, as Dr. Selwyn's imputation of a higher sales price would imply, then it is difficult to understand how the same ratepayers bear any risk with respect to the value of that asset.

Second, the claim that the realized sales price was lower than the forecasted fair market value due to the alleged fire-sale nature of the transaction does not bear scrutiny. The public nature of the transaction process ensured that all potential buyers were aware of the opportunity so that the realized price would reflect the market's maximum valuation. A longer process would not necessarily have resulted in a higher realized price: it is unlikely that new potential buyers with higher valuations would be found and

changes over time in the underlying information provided to all parties generally had the effect of reducing the market price.

Third, the fact that QCI was obliged to sell assets to avoid bankruptcy did not reduce the realized price below what it would have been for a sale under other circumstances. The existence of an objective reason for an immediate sale helps to negate the problem of asymmetric information. Under ordinary circumstances, the seller knows its financial prospects better than any potential buyer. That fact generally depresses the market price because any price at which the seller was willing to sell would be one that was higher than its perception of the value of the asset. Because QCI was selling Dex to raise cash, this problem did not arise. QCI's objective need to sell the asset provides a reason, other than better information about Dex's prospects, for accepting a buyer's offer.

Fourth, Dr. Selwyn's own attempts to value Dex and the present value of the current imputation from Dex are not credible estimates of Dex's market value at the time of the transaction. Dr. Selwyn relies on outdated data regarding demand volumes and financial projections and ignores long term effects of technological change on the market.

2. Ratepayer Risk from Dex Ownership

In unregulated competitive markets, customers pay for goods and services received and do not on that basis acquire an equity interest in the supplier. From an economic perspective, only to the extent that ratepayers actually face risk with respect to changes in the value of an asset should the gains (or losses) from sale of that asset be shared between shareholders and ratepayers.

Customers of both Yellow Pages and telecommunications services have choices in Washington today. There is no franchised monopoly service, and if the value of a Qwest asset should fall, no customer is obliged to pay a higher price for Yellow Pages advertisements or telephone service. In that sense, telephone ratepayers face no risk from potential loss in value of the assets used in the Yellow Pages operation and thus those ratepayers have no automatic entitlement to share in the proceeds of the sale.

The fact that a portion of the value of the asset stems from network externalities and a first-mover advantage does not confer a share of the sales proceeds on ratepayers. The first mover in this market was the predecessor of Dex, and the business was begun long before either Yellow Pages or telephone services were regulated or granted any kind of a monopoly. Indeed, Yellow Pages never received a monopoly franchise and has competed with other directories and other forms of local advertising from its inception.

3. Subsidy Flows Distort Competition in Local Advertising and Telecommunications Markets.

Dr. Blackmon, Dr. Selwyn and Mr. King emphasize the ratepayers' stake in the Qwest Dex Yellow Pages operation and point to the ratepayer harm that would come from any reduction in the current and future levels of imputation that would keep the prices of regulated services below what they otherwise would be. This long-standing public policy has a negative effect on the local telecommunications market. There is no debate that the local exchange market is open to competition in Washington, as this Commission and the FCC determined respectively in July and December of 2002. Implicit contribution flows from Yellow Pages imputation to support prices of regulated telecommunications services thus distort competition in these markets, lowering prices below what they otherwise would be and discouraging entry from otherwise efficient potential entrants. A major thrust of the 1996 Telecommunications Act (Section 254, (k)) was to eliminate such subsidy flows.

4. Mr. King's Proposed Disposition of the Sales Proceeds.

Mr. King recommends that 10 percent of the sales proceeds be returned immediately to current Qwest local exchange customers through bill credits. The remaining 90 percent would become a "regulatory liability" which would be amortized through revenue requirement reductions over a 15 year period. In addition, the unamortized portion of the liability would be taken as a reduction against the rate base, further reducing the

revenue requirement. The net effect, as Mr. King characterizes it, is to "front-load" the ratepayer benefit.

Even apart from the question of the ownership of the Dex asset, the economic problem with these proposals is that they ignore the primary function of prices in a market economy: to signal the efficient disposition of scarce resources. Mr. King's plan would reduce prices of local telecommunications services today without regard to the cost of supplying such services today, and raise them tomorrow, similarly without regard to cost. Customers who use prices to determine which services (or packages of services) to buy, how much of those services to buy and which suppliers to buy them from would have no cost-based guidance for that decision. New entrants who compete against Qwest's local exchange prices would have no efficient signal regarding their ability to compete successfully against local exchange market prices.

5. Summary

In sum, the various proposals to credit ratepayers with the proceeds of the Dex sale create more problems than they solve. First, the process by which Dex was sold was open and arms' length, so that the realized price is the most accurate measure possible for the fair market value of the asset. Second, Qwest's customers have no economic claim on the Dex sale proceeds, as they are not and have not been in any relevant sense at risk concerning the value of the asset. Third, schemes to credit local exchange ratepayers for contribution from Yellow Pages (or any other service) are inefficient and

unsustainable because the local markets in question are opened to competition. Forcing Qwest or any telecommunications company to reduce service prices irrespective of cost or demand conditions is not a consumer benefit.

II. IDENTIFICATION OF WITNESS

Q. PLEASE STATE YOUR NAME, TITLE, AND ADDRESS.

A. My name is William E. Taylor. I am Senior Vice President of National Economic Research Associates, Inc., One Main Street, Cambridge, MA 02142.

Q. PLEASE REVIEW YOUR EDUCATION, WORK EXPERIENCE, AND PRESENT RESPONSIBILITIES.

A. I have been an economist for over thirty years. I received a B.A. degree in economics (Magna Cum Laude) from Harvard College in 1968, a master's degree in statistics from the University of California at Berkeley in 1970, and a Ph.D. in Economics from Berkeley in 1974, specializing in industrial organization and econometrics. I have taught and published research in the areas of microeconomics, theoretical and applied econometrics, and telecommunications policy at academic institutions (including the economics departments of Cornell University, the Catholic University of Louvain in Belgium, and the Massachusetts Institute of Technology) and at research organizations in the telecommunications industry (including Bell Laboratories and Bell Communications Research, Inc.). I have testified on telecommunications economics before numerous state regulatory authorities, federal regulators in the U.S., Canada,

Mexico and New Zealand, federal and state congressional committees, and courts concerning incentive regulation, productivity, access charges, mergers, antitrust issues and pricing for economic efficiency. A copy of my vita listing publications and testimonies is attached as Exhibit WET-2.

Q. HAVE YOU TESTIFIED PREVIOUSLY BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION?

A. Yes. I testified before the Washington Utilities and Transportation Commission ("WUTC") on behalf of U S WEST in Docket Nos. UT-990300 and UT-003006 regarding economic issues of network interconnection, and in Docket No. UT-991358 on the likely effects of the Qwest merger on competition. I testified on behalf of Qwest Corporation in Docket No. UT-000883 regarding the classification of business services as competitive.

III. PURPOSE AND SUMMARY OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to examine the economic issues raised in the Direct Testimonies of Dr. Selwyn and Dr. Blackmon (on behalf of Commission Staff) and the Response Testimony of Mr. King (on behalf of the Department of Defense and other Federal Executive Agencies "DOD/FEA") regarding four issues:

- the valuation of Dex and the imputation of the difference between estimates of the fair market value and the realized price;

- the relative assessment of risk and return between Qwest customers and shareholders regarding the ownership of Dex;
- the economic and policy problems of continued contribution from Dex to the local exchange markets either through traditional imputation or by treating Dex sale proceeds as regulated telephone company revenue; and
- the economic distortions that would flow from Mr. King's proposal to amortize the sale proceeds over 15 years.

In what follows, I will use the following abbreviations regarding the various companies involved in this transaction. Qwest Communications International Inc. (QCI) is the ultimate parent company, owning Qwest Service Corporation (QSC) which, in turn, owns, (i) Qwest Dex Holdings, Inc. which owns the directory publishing operations, Qwest Dex, Inc. (Dex), and (ii) the operating telephone company Qwest Corporation (QC) which is the incumbent local exchange carrier in Washington and 13 other states.

IV. VALUATION

Q. PLEASE DESCRIBE DR. SELWYN'S THEORY OF THE VALUATION OF THE DEX SALE TRANSACTION.

A. Dr. Selwyn claims that the realized sales price is less than the fair market value of the Dex operation because the sale is taking place under distress conditions.[1] Using several analysts' estimates of the fair market value of Qwest Dex, Dr. Selwyn calculates a range of alleged fair market values[2] and argues that:

> if the Commission were to authorize the sale, it should impute the Washington share of the fair market value of the directory publishing assets, rather than

[1] Direct Testimony of Lee L. Selwyn, dated March 18, 2003 ("Selwyn"), page 6.
[2] Selwyn, pages 24 to 40.

simply the Washington share of the BEGIN QWEST CONFIDENTIAL ***** END QWEST CONFIDENTIAL sale proceeds, in order to properly compensate Washington ratepayers for loss of the "regulatory asset" of the directory business.[3]

Thus, Dr. Selwyn claims that Washington ratepayers are entitled to more than the Washington share of the entire proceeds of the sale because the circumstances of the sale resulted in the asset being sold for substantially less than his estimate of its fair market value.

Q. DOES DR. SELWYN BASE HIS RECOMMENDATION TO THE COMMISSION ON THAT FINANCIAL ANALYSIS?

A. No, Dr. Selwyn bases his recommendation on a different measure of the fair market value of Dex. On the theory that the sale should hold ratepayers harmless, Dr. Selwyn calculates the annuity value of the imputation currently flowing from Dex Yellow Pages to regulated telecommunications services. He makes three assumptions: (i) the imputation formula and rate of return regulation will remain in place, unchanged, forever; (ii) the imputation amount will grow at the long-term growth rate for EBIDTA assumed by Lehman Brothers in August 2002; and, (iii) the relevant discount rate is 10.0 percent. Under these assumptions, the net present value of the perpetual imputation stream is $1,588.0-million, which, using his factor for the Washington share of revenue or earnings to allocate the sales proceeds, amounts to an enterprise value of

[3] Selwyn, page 52, lines 9 to 13.

BEGIN QWEST CONFIDENTIAL **********.[4] END QWEST CONFIDENTIAL It is this amount that Dr. Selwyn recommends be used as the fair market value of Dex for Washington ratemaking purposes.[5]

Q. ARE THESE ASSUMPTIONS REASONABLE?

A. No. Nothing in law or policy has granted the Washington ratepayer the claim in perpetuity on which Dr. Selwyn bases his calculation. It is inconceivable in a policy regime that forbids subsidy and encourages level-playing-field competition that an overt subsidy to services for which firms are currently actively competing would remain in place, growing at a constant rate forever. It is particularly difficult to believe that such a policy would have continued under rate of return regulation as the set of affected services became smaller, as services were reclassified as competitive and as the effect of imputation became the dominant factor in pricing services.

A. The actual sales price in an open, competitive transaction is a better measure of the value of an asset than forecasts of fair market value.

Q. WHAT IS THE FAIR MARKET VALUE OF AN ASSET?

A. In economics, fair market value generally represents the price at which an asset would be sold in a competitive market in which many willing buyers and sellers meet.[6] Around this narrow definition, a rich and complex theory of procurement and auctions has evolved which examines the institutional arrangements—generally an auction or its

[4] Selwyn, page 54, Table 3.
[5] Selwyn, pages 109-110.
[6] U.S. capital markets are a textbook example of such a market: there are many informed and independent buyers and sellers of assets.

equivalent—under which a seller can expect to receive the maximum price that any buyer would be willing to pay for the asset.[7]

Q. PLEASE DESCRIBE THE PROCESS BY WHICH DEX WAS SOLD.

A. The sale was the second-largest leveraged buyout in history. The process amounted to an auction among the set of all interested and qualified bidders. The investment bankers and the Company publicized the sale among all potential buyers. Thirty-nine parties signed the required confidentiality agreements and received the descriptive information in April 2002. Some of the independent bidders formed consortia and independent first-round bids were received from eight groups. Of the eight bids, six were for all of the Dex properties.

Comparable preliminary bids ranged from $7 to $10 billion, and five groups ultimately chose to continue: Carlyle/MDP/Welsh, Carson; Apollo/Oaktree; Apax/Hicks, Muse; Liberty Media; and Blackstone Group/Thomas H. Lee/Providence/Bain. Management presentations were made to all five groups, and each group was encouraged to undertake due diligence.

Between April and July 2002, several events affected the on-going auction. First, the due diligence process uncovered some one-time benefits in DEX's estimated 2002

[7] For readable summaries, see R. P. McAfee and J. McMillan, "Auctions and Bidding," *Journal of Economic Literature, Vol. XXV* (June, 1987), pp. 699-738, or P. Milgrom, "Auctions and Bidding: A Primer," *Journal of Economic Perspectives*, Summer 1989, pp. 3-22.

EBITDA.[8] Second, Dex changed the publication schedule of some its Yellow Pages books, which, under point of publication accounting,[9] resulted in changes in annual revenue and EBITDA. Third, Dex changed its accounting methods from point of publication to deferral and amortization accounting. The net effect of these changes was to lower prices below the levels in the preliminary bids, which were generally expressed as multiples of estimated 2002 EBITDA. By July, two private equity groups remained: Welsh, Carson/Carlyle, and the Blackstone Group. After a careful analysis of the bids was undertaken, QCI selected the Welsh, Carson/Carlyle bid for the entire asset with closing staged over two geographic regions.

Q. IS THERE ANY EVIDENCE THAT THIS PROCESS ELICTED THE MAXIMUM PRICE?

A. Yes. First, several bidders dropped out of the process, presumably because the price was higher than their willingness to pay. Second, at the end of sale, the buyer was unable to raise the full purchase price from external debt and equity markets. As part of the transaction, QCI agreed to receive up to $300 million of notes from the buyer and up to $42 to $217 million of the buyer's equity under certain conditions. If Dr. Selwyn were even remotely correct in his claim that

> it is clear that the nominal $7.05 billion sale price BEGIN QWEST CONFIDENTIAL **********

[8] For accounting purposes, such adjustments are appropriate, but for forecasting future EBITDA levels and growth, analysts try to remove the effects of such events.

[9] Under point of publication accounting, all revenue for a Yellow Pages book is recognized in the period in which the first book is delivered.

********** [10] END QWEST CONFIDENTIAL

it is difficult to understand why the buyer had difficulty financing the purchase of an asset at a price that is "clear(ly)" well short of the market price.

Q. WHY DOES THIS TYPE OF SALE GENERATE THE MAXIMUM REVENUE FOR THE SELLER?

A. For corporate acquisitions, all bidders generally have access to the same information and are generally as equally risk-averse as the seller. Differences in valuations of the asset are unlikely to arise because of differences in valuation methods—these are standard among financial analysts—but can arise from differences in synergies with the buyer's own assets. Nonetheless, no bidder would permit the asset to be sold to another party at a price less than that bidder's own valuation; to do so would amount to turning away profits. Thus, the sales price for the asset must be at least as high as the second-highest valuation among the bidders.[11]

Q. HOW DOES THE SELLER'S VALUATION OF THE ASSET AFFECT THE SALES PRICE?

A. Generally speaking, it doesn't. As in the chair auction example, once the seller agrees

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[10] Selwyn, page 39.

[11] To see this, consider the auction of an antique chair. Suppose buyers **A**, **B** and **C** have widely different valuations: **A** would be willing pay $500, **B** no more than $300, and **C** only $200. As the bid price rises, **C** drops out at $201and **B** drops out at $301. **A** need only pay $301 for an item for which he would be willing to pay $500, so the second-highest valuation essentially determines the sales price. In this example, no bidder permits the chair to be sold to someone else at price less than his own valuation.

to sell the asset, it is the valuation of the buyers that determines the sales price.

Q. WHAT IS THE ROLE OF ANALYSTS' VALUATIONS IN THE PROCESS OF SELLING AN ASSET?

A. Analysts' valuations are estimates of the financial value of the asset to a buyer based on historic data and assumptions about the future. They are fundamentally forecasts of the price that would result from a properly-conducted sale. Public and private analysts' valuations are used by buyers and sellers as part of the due diligence process. Buyers use the information to guide their determination of the maximum price they would be willing to pay, and sellers use the information to decide whether to sell the asset and to assure stockholders that the sale is likely to be in their financial interest.

Q. ARE ANALYSTS' VALUATIONS GENERALLY ACCURATE ESTIMATES OF THE SALES PRICE OF AN ASSET?

A. Not always, depending on the asset. For example, real estate valuations, or art and antique appraisals are frequently poor predictors of the selling price, generally because buyers have widely different willingness to pay for such assets and the auction processes by which they are sold do not ensure that all interested and qualified buyers are present. For corporate acquisitions, analysts generally provide a range of valuations as consistent with fair market value, where the ranges are based on alternative assumptions about future events. These ranges of valuations are generally more accurate forecasts of the price resulting from an auction because most qualified and

interested bidders are aware of the sale and their valuations are reflected in the auction price.

Q. FOR A GIVEN VALUATION, IS THERE ANY SPECIAL SIGNIFICANCE TO THE MID-POINT OF THE RANGE?

A. It depends on what generates the range. For example, if a range reflects different long-run growth rates for revenue or earnings, the mid-point of the range would reflect a middle-of-the-road view (with respect to growth) of the value of the firm. On the other hand, if the range reflects the effect of two inconsistent assumptions (e.g., including or excluding some portion of the asset), the mid-point of the range has no significance.

In particular, an estimated range for the fair-market value of an enterprise is just that: a range of estimated fair-market values. Thus, any realized sale price within the range is consistent with the analyst's estimate of fair market value.

Q. WHEN ANALYSTS PRESENT DIFFERENT RANGES OF FAIR MARKET VALUES FOR DIFFERENT SCENARIOS, IS THERE ANY SPECIAL SIGNIFICANCE TO AN AVERAGE OF THE MID-POINTS OF THE RANGES?

A. No, except as a descriptive statistic which cannot be taken as an unbiased measure of average fair market value in any statistical sense. The reason should be obvious. Suppose an analyst considers three basic scenarios for valuation consisting of (a) high revenue growth, (b) medium revenue growth, and (c) low revenue growth. An average of the mid-points of these three ranges is not a good measure of anything. Suppose

high revenue growth is by far the most likely scenario. Then an unweighted average of the three mid-points would underestimate the likely value of the asset. Suppose the analyst looked at six additional scenarios examining in detail alternatives for option (c). An average of the mid-points of the ranges for (a), (b), and the 6 versions of (c) would be heavily weighted towards the valuations in (c).

Q. DR. SELWYN, DR. BLACKMON AND MR. KING CLAIM THAT THE SALE PRICE IS BELOW FAIR MARKET VALUE BECAUSE OF THE ALLEGED FIRE-SALE CIRCUMSTANCES SURROUNDING THE SALE. DO YOU AGREE?

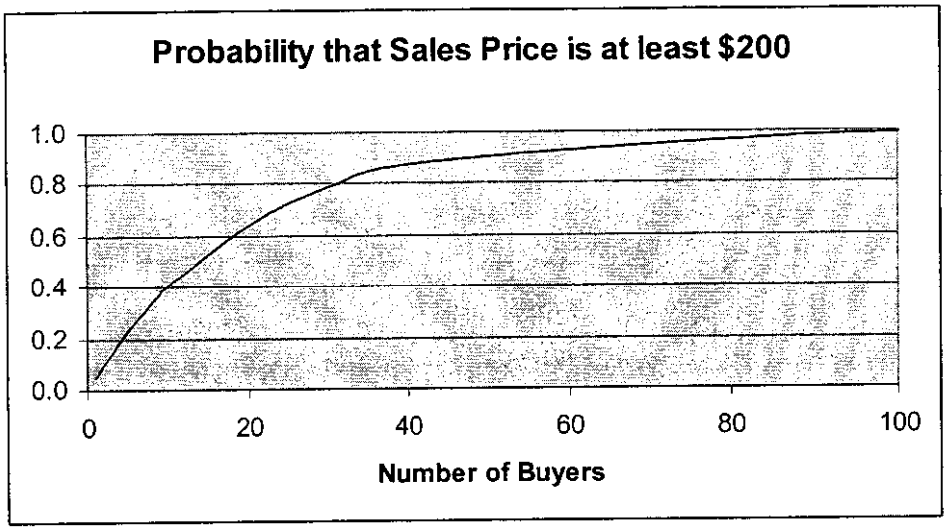
A. No. First, the actual sale price is well within the ranges of fair market values estimated at the time of the sale. Second, while I agree that it was common knowledge that Qwest wanted to sell assets (including Dex) to reduce debt and to attempt to avoid bankruptcy, it does not follow from that knowledge that the sales process would produce a price below fair market value.

Q. PLEASE EXPLAIN.

A. A fire-sale is one in which it is known that an asset must be sold and sold by a particular point in time. In selling assets like houses or furniture, a forced quick sale reduces the expected price to the seller because not all interested parties are aware that the sale is taking place and do not participate. People may have widely different valuations of these assets, and to have a reasonable expectation of receiving a price

towards the high end of that range, the asset must be on the market long enough so that people with unusually high valuations will have participated.

For example, suppose valuations of an asset were normally distributed across the population of potential buyers with mean $100 and standard deviation $50. The probability of observing a buyer having a valuation greater than $200 is about 0.05. If the asset is sold quickly so that only 10 potential buyers see it, the probability of realizing a sales price greater than $200 is only about 0.4 (=1.0 – 0.95^10). If more time passes and 100 buyers are brought into the process, the probability of a sales price greater than $200 is a near-certainty. If, on average, a new buyer enters the process each day, a 10 day sale will likely produce a smaller price than a sale extended over 100 days. See the Figure below.



This process is the source of the intuition that the requirement to sell an asset rapidly would produce a lower sales price.

That intuition does not apply to the sale of corporate assets like Qwest Dex for at least two reasons. First, the range of valuations across the population of buyers is much narrower for purchasing corporate assets like Dex. Buyers are sophisticated, are provided with the same set of basic financial data, and use the same publicly-available tools for valuing the asset. Consumer preferences and tastes do not come into the calculation of willingness to pay. Second, all potential buyers are made aware of the impending sale of the asset, and selling the asset over a longer period of time would not be likely to induce higher-valuation buyers to enter the auction or to change the maximum valuation among the buyers.

Q. BUT DOESN'T THE FACT THAT QWEST WAS UNDER PRESSURE TO SELL

DEX REDUCE THE PRICE THE SELLER COULD EXPECT TO OBTAIN?

A. Possibly, but two factors suggest such pressures may not have a negative effect on assets prices in these circumstances. First, in an auction, it is the buyer's valuation of the asset that determines the price, not the seller's. Why would a bidder permit the asset to be sold to another party at any price below its valuation, even if it were known that Qwest were under pressure to sell? For this reason, the pressures on Qwest to sell may not have a depressing effect on the sales price. Second, the fact that Qwest was under external pressure to sell Dex reduces what economists call the "lemons" problem in selling an asset under conditions of asymmetric information.[12] The problem is that not all parties have the same information regarding the future financial prospects for the asset. No party knows better than Qwest what Dex's future prospects in its markets actually are. In an unforced sale, if Qwest were willing to sell Dex for X, potential buyers would have to deal with the fact that the best-informed party (i.e., Qwest) valued the enterprise at X or less. On the other hand, if Qwest were forced to sell to raise cash, this problem would not arise.

[12] See Akerloff, George. "The Market for Lemons: Quality Uncertainty and the Market Mechanism." *Quarterly Journal of Economics* (August 1970): 488-500.

B. A sales price below an average of mid-points of ranges of estimated fair market values does not represent less than a fair market price.

Q. DR. SELWYN ASSERTS THAT THE DIFFERENCE BETWEEN THE SALES PRICE AND THE MID-POINT OF VARIOUS RANGES OF ESTIMATED FAIR MARKET VALUATIONS SHOWS THAT THE REALIZED PRICE WAS LESS THAN THE FAIR MARKET VALUE. DO YOU AGREE?

A. No, I do not agree that the realized sales price represents less than the fair market value of the asset. Dr. Selwyn bases this claim, in part, on the difference between the sales price and the mean of ranges of fair market valuations provided by various bankers and analysts at various points in time. I explained above why mid-points of ranges and means of mid-points of different ranges are not necessarily valid estimates of anything.

Dr. Selwyn discusses 5 sets of analysts' valuations. The means of mid-points of scenarios of these valuations are set out below. Each of these valuations, Dr. Selwyn claims, shows that the realized price was less than the fair market value. However, the actual data tell a different story. Two of the five valuations (by Lehman Brothers and Merrill Lynch) are dated August 19, 2002 and reflect the latest values of historical and estimated future data, particularly Dex's estimates of 2002 EBITDA which were falling over time. For both of these two valuations, the realized sales price fell in the range of fair market values in five of the six relevant scenarios. Six valuation scenarios were calculated using earlier data by Bear Stearns, Credit Suisse First Boston and J.P.

Morgan, and the realized price fell within or above the valuation range in three of them.

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Analysts' Valuations as Reported by Dr. Selwyn			
Analyst	Date	Valuation	Source
Lehman Brothers	8/19/02	**********	Selwyn Table 1
Lehman Brothers	2/3/02	****	Selwyn p. 30
Merrill Lynch	8/19/02	****	Selwyn p. 31
Bear Stearns et al	Q1 2002	****	Selwyn Table 2
Selwyn	April 2002	****	Selwyn p. 35

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Dr. Selwyn's averaging of the mid-point of ranges of fair market values conceals the fact that the realized price fell within the fair market value range in 10 of the 12 relevant scenarios based on the most relevant data.

Q. DO YOU AGREE WITH DR. SELWYN'S SUMMARY ESTIMATE OF THE RANGE OF THE ALLEGED SHORTFALL?

A. No. His summary estimate of this alleged shortfall is BEGIN QWEST CONFIDENTIAL ********** ********** [13] END QWEST CONFIDENTIAL Dr. Selwyn picks and chooses the opinions he cites in that range in a manner that exaggerates the alleged shortfall. The lower end of Dr. Selwyn's range is based on the average of the midpoints of the 6 Merrill Lynch scenarios shown in Confidential Exhibit No. LLS-9C. The upper end of

[13] Selwyn, at page 39.

the range is not based on an average of midpoints of an analyst's scenarios but on the upper bound of the highest scenario considered by the analyst (Lehman Brothers) in Confidential Exhibit No. LLS-7C. If we picked the lower bound in the same way Dr. Selwyn picked his upper bound, the result would be BEGIN QWEST CONFIDENTIAL ********** END QWEST CONFIDENTIAL, and Dr. Selwyn would have to conclude that the data show the realized sales price for Dex represents anywhere from BEGIN QWEST CONFIDENTIAL ********** ********** END QWEST CONFIDENTIAL. In particular, we cannot conclude from these data that the realized price is less than the estimated fair market value. Moreover, the fair market value is the realized price in a competitive auction, so Dr. Selwyn's comparisons of analysts' estimates is irrelevant.

C. Dr. Selwyn's estimate of the alleged shortfall is overstated.

Q. DR. SELWYN CALCULATES HIS OWN DISCOUNTED CASH FLOW ESTIMATE OF THE VALUE OF DEX.[14] IS THAT CALCULATION REASONABLE?

A. No. Dr. Selwyn suggests his calculation "should be of particular interest to the WUTC because it represents the value that Dex's management believed the Dex business to have just prior to the date when the sale transaction was agreed to"[15] However, Dr. Selwyn's Confidential Exhibit No. LLS-10C shows that the levels and growth rates for

[14] Selwyn, page 35.
[15] Selwyn, page 35, lines 1 to 3.

revenues and EBITDA were reported as "financial projections of Dex management for 2002-2006" in a Lehman Brothers Confidential Descriptive Memorandum dated April 2002. According to the Merrill Lynch Board Presentation of August 19, 2002, (*see* Confidential Exhibit LLS-6C, page 1) "both bidders have revised their offers" at some point between August 7 and August 19. Thus, the growth projections and valuations in the Lehman Brothers and Merrill Lynch valuations of August 19, 2002 are a better representation of the valuation of Dex at the time when the transaction was agreed to.

Q. WHY IS THIS POINT SO IMPORTANT?

A. This point is important because if we recalculate Dr. Selwyn's Confidential Exhibit LLS-10C using his method and all of his assumptions, except replacing his revenue and EBITDA levels and growth rates (from before April 2002) with those used in the August 19, 2002 investment bankers' Board presentations, we obtain an Enterprise Value of BEGIN QWEST CONFIDENTIAL ********** ********** ********** END QWEST CONFIDENTIAL *See* Confidential Exhibit WET-3C

Q. DO YOU HAVE OTHER CONCERNS WITH DR. SELWYN'S TESTIMONY REGARDING HIS DCF CALCULATION?

A. Yes, there is a second concern with Dr. Selwyn's conclusion based on his DCF calculation. The method he uses is essentially that used by Bear Stearns in a February

5, 2002 Presentation to Quasar (Confidential Exhibit LLS-10C). For the years 2002-2006, it calculates unlevered free cash flow. In 2006, it calculates a terminal value equal to seven (7) times the 2006 value of EBITDA. The net present value of these cash flows is then taken to be the implied Enterprise Value of the asset. Critical to this calculation, of course, is the assumption that the terminal value of Dex's cash flows is equal to 7.0 times EBITDA. While that assumption has some support in valuations based on comparable transactions and transactions in other industries, it is no more (or less) reasonable to apply that assumption in 2002 than in 2006. Indeed, since the 2002 level of EBITDA is estimated far more precisely (in August 2002) than the 2006 level of EBITDA, one might think that applying the assumption in 2002 would be more accurate. In any case, when Enterprise Value is measured as 7.0 times estimated 2002 EBITDA, the resulting fair market values are BEGIN QWEST CONFIDENTIAL ********** END QWEST CONFIDENTIAL (using Dr. Selwyn's April 2002 estimate of 2002 EBITDA) or BEGIN QWEST CONFIDENTIAL ********** END QWEST CONFIDENTIAL (using the investment bankers' August 2002 estimates of 2002 EBITDA). *See* Confidential Exhibit WET-3C

D. Dr. Selwyn's recommendations do not follow from his analysis

Q. DOES DR. SELWYN RECOMMEND THAT WASHINGTON RATEPAYERS' COMPENSATION BE BASED ON THE ANALYSTS' MEASURES OF FAIR MARKET VALUE?

A. No. Neither Dr. Selwyn nor Dr. Blackmon recommends use of the analysts' estimates

of fair market value in their calculation of a Washington ratepayer entitlement. Dr. Blackmon would calculate the entitlement as the entire (Washington portion) of the sales proceeds supplemented by "part of" the $500 million identified with regulatory approvals.[16] In his recommendation to the WUTC, Dr. Selwyn[17] ignores his alleged shortfall between the realized price and the analysts' estimates of fair market value. Instead, he imputes a fair market value for Dex as the annuity value of the estimated stream of imputation from Dex Yellow Pages to regulated local exchange services.

Q. WHAT JUSTIFICATION DOES DR. SELWYN USE FOR THIS METHOD OF DETERMINING A WASHINGTON RATEPAYER ENTITLEMENT?

A. He argues that a "ratepayer indifference public interest test" would require that Dex be valued at a level, which, when combined with an earnings-based Washington allocator, would produce the same level of contribution as continuing the current imputation process.[18] The calculation is shown in Dr. Selwyn's Table 3, and the resulting valuations are the source of the valuations he recommended to the WUTC.[19]

Q. DOES THIS CALCULATION MEASURE IN ANY SENSE THE FAIR MARKET VALUE OF DEX?

A. No. It obviously makes no reference to financial estimates of the value of Dex or to the

[16] Direct Testimony of Glenn Blackmon, dated March 18, 2003 ("Blackmon"), at pages 24 to 25.
[17] Selwyn, at pages 109-110.
[18] Selwyn, at page 54.
[19] Selwyn, at page 110.

realized market price for Dex. Rather, it purports to calculate a sum of money X such that ratepayers would be indifferent between receiving X today and receiving continued imputation from Yellow Pages in perpetuity. There is no reason to think that buyers would be willing to pay such an X for Dex.

In fact, Dr. Selwyn's own methods imply that this valuation exceeds a fair market price for Dex. A value of BEGIN QWEST CONFIDENTIAL ********** END QWEST CONFIDENTIAL is roughly BEGIN QWEST CONFIDENTIAL ********** ***** END QWEST CONFIDENTIAL the average of the mid-points of the Lehman Brothers' valuations in Dr. Selwyn's Table 1,[20] BEGIN QWEST CONFIDENTIAL ********** END QWEST CONFIDENTIAL than the average of the mid-points of the Merrill Lynch valuations (Confidential Exhibit LLS-9C) and about BEGIN QWEST CONFIDENTIAL ********** END QWEST CONFIDENTIAL than the average of all valuations (Bear Stearns, Credit Suisse First Boston and J.P. Morgan) in Dr. Selwyn's Table 2.[21] Ignoring averages, Dr. Selwyn's valuations are above the range of fair market values in 5 of the 6 relevant scenarios in the Lehman Brothers August 19, 2002 report (Confidential Exhibit LLS-7C) and in all 6 of the scenarios in the Merrill Lynch report (Confidential Exhibit LLS-9C).

[20] Selwyn, at page 28.
[21] Selwyn, at page 34.

Q. HOW DO YOU INTERPRET THE FACT THAT DR. SELWYN'S CALCULATION EXCEEDS HIS MEASURES OF THE FAIR MARKET VALUE OF DEX?

A. Dr. Selwyn shows that under certain assumptions, the net present value of a perpetual annuity equal to the current level of Yellow Pages imputation in Washington (adjusted for future growth) exceeds analysts' estimates of the market value of Dex and exceeds the actual, realized price at which Dex was sold. Adopting all of Dr. Selwyn's assumptions for the purpose of argument, that fact implies that the current imputation formula represents more than the Washington share of the entirety of Dex's value. If imputation was designed to use a portion of Dex earnings to reduce local exchange prices, it has been set at too high a level.

Q. DOES THIS CALCULATION MEASURE THE VALUE OF DEX TO THE WASHINGTON RATEPAYER?

A. No. The assumptions in Dr. Selwyn's calculation are not reasonable. First, the calculation assumes that imputation will grow at the long-term growth rate of EBITDA. Second, the calculation requires that this growing stream of imputation will continue in perpetuity. While the growth assumption is merely arbitrary, the view that the Washington ratepayer has an entitlement to a permanent flow of imputation from Yellow Pages has no support in law or WUTC policy. From an economist's perspective, it is extremely unlikely that a growing subsidy flow to local exchange services will continue forever. The local exchange market in Washington has been

opened to competition, and requiring that a perpetual flow of support from an unregulated, non-telecommunications service be used to support one supplier's prices in that market cannot be maintained as reasonable public policy. In addition, as competition has grown in Washington telecommunications markets, the number and volume of services whose prices are controlled by rate of return regulation is getting smaller and smaller, and the effect on the market of a growing subsidy to a shrinking base of services will become unsustainable.

E. The difference between a sales price and a higher estimated average valuation does not represent a ratepayer entitlement.

Q. LEAVING ASIDE THE NUMBERS, IS DR. SELWYN'S BASIC PREMISE CORRECT: THAT RATEPAYERS ARE ENTITLED TO COLLECT HIS CALCULATION OF THE FULL FAIR MARKET VALUE OF DEX RATHER THAN JUST THE AMOUNT REALIZED BY THE SALE?

A. No. Dr. Selwyn claims that ratepayers are entitled to receive the entire fair market value of the asset (as he calculates it) and that the circumstances surrounding the sale of Dex caused the sales price to fall below estimates of that fair market value.[22] Similarly, Dr. Blackmon's recommends that Washington ratepayers receive their full share of the entire purchase proceeds plus "part of" a $500 million reserve because "the sale price is lower than either the full business enterprise value of Dex or the net present value of

[22] I disagree with both assertions. Ratepayer entitlement is discussed below in Section V. As discussed above, Dr. Selwyn's measures of the fair market value of the asset overstate the value implied by the evidence.

expected future imputation benefits."[23] However, even under these circumstances, ratepayers would still not be entitled to recover the difference between the sales price and Dr. Selwyn's estimate of fair market value.

Q. WHY NOT?

A. According to Dr. Selwyn's theory, ratepayers are entitled to the sales proceeds because ratepayers, not stockholders, are at risk for the value of the asset. However, if ratepayers are to be made whole for allegedly bad decisions made by Qwest or Dex, one cannot then argue that ratepayers bear the risk associated with owning the asset, because it is clear they do not bear any risk.

V. THE RELATIVE ASSESSMENT OF RISK AND RETURN BETWEEN QWEST CUSTOMERS AND SHAREHOLDERS REGARDING THE OWNERSHIP OF DEX

Q. WHAT ECONOMIC PRINCIPLES ARE USEFUL TO DETERMINE WHO IS ENTITLED TO THE PROCEEDS OF THE SALE OF AN ASSET OWNED BY A REGULATED FIRM?

A. As always, the economic standard by which regulatory decisions are measured is what would happen in unregulated, competitive markets. In such markets, customers pay for the goods and services they buy, and even though their purchases fund the supplier—pay for operating expenses and capital equipment—at the end of the day, customers have acquired no equity interest in the firm. No matter how frequently I rent from Hertz, they never send me a check at the end of the year when they sell off their old

[23] Blackmon, at page 25.

fleet of cars.[24]

This is the case in competitive markets despite the fact that consumers effectively share the burden of certain risks with the firm's stockholders. For example, when it freezes in Florida, owners of orange groves may suffer a reduction in the fair market value of their asset. At the same time, prices paid by consumers for orange juice may rise. Nonetheless, when an orange grove is sold, stockholders keep the entire amount of the sale proceeds, and consumers receive no explicit or implicit share.

Q. HOW IS AN ASSET OWNED BY A REGULATED MONOPOLIST DIFFERENT FROM THE SALE OF AN ORANGE GROVE?

A. For an economist, the relevant difference is that for a regulated firm having a monopoly franchise, customers (by assumption) cannot take their business elsewhere. In general, the regulated firm is subject to earnings limitations in exchange for a government-protected monopoly franchise and the opportunity to earn a "reasonable" return on its investment. In this environment, there may be circumstances in which ratepayers bear some risk of loss from assets of the regulated firm: if the value of the asset declines and additional depreciation is reflected on the firm's books, costs—and

[24] This intuition is the source of the DC Circuit Court of Appeals standard that "As a general rule, utility service ratepayers "pay for service" and thus "so not acquire any interest, legal or equitable, in the property … of the company." *Illinois Public Telecommunications Association v. Federal Communications Commission and United States of America*, 326 U.S. App. D.C. 1 at 43: 117 F.3d 555 (July 1, 1997).

therefore regulated prices—will be higher than they otherwise would. Because the firm is a franchised monopolist, ratepayers must pay the higher price, and therefore bear at least some the risk with respect to the asset. This is the economic logic that underlies the D.C. Court of Appeals decisions in Democratic Central Committee and Illinois Public Telephone.[25]

Q. DOES THIS LOGIC APPLY TO THE DEX TRANSACTION?

A. No. Qwest in Washington does not possess a franchised monopoly for either its Yellow Pages operations or its regulated local exchange services. Customers of both of these operations can go elsewhere if Qwest attempts to offset changes in the value of an asset by higher prices. Thus, any loss of value of a Qwest asset that increases the cost of providing service (Yellow Pages or telecommunications) is not borne by Qwest's customers.

Dex Yellow Pages competes in the local advertising market: i.e., a publishing business unrelated to the provision of a telephone network. From a telephone ratepayer's perspective, the business is ancillary: a clever way to turn a regulatory requirement (to publish a directory of phone numbers) into a paying business by charging for advertising. From the telephone customer's perspective, the business is riskless: if the

[25] *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Transit Commission*, 458 F. 2d 786 (D.C. Cir. 1973), reh den, cert den, 415 US 935 (1973). *Illinois Public Telecommunications Association v. Federal Communications Commission and United States of America*, 326 U.S. App. D.C. 1, 43, 117 F.3d 555 (July 1, 1997).

business succeeds, telephone prices would be set below where they otherwise would and if the business fails (if Yellow Pages advertising revenues failed to cover the incremental costs of the advertising business), telephone ratepayers would not face prices above where they otherwise would be for telephone services, because the cost of providing telephone service does not change. As technological change (particularly the internet) erodes the position of the printed Yellow Pages directory, ratepayers neither provide capital for Dex to expand its business nor suffer any loss associated with the loss in value of the Dex assets.

The prospect of paying higher, unsubsidized, prices for telephone services without imputation through the rate-of-return mechanism does not, by itself, establish a ratepayer claim of ownership of the Company's assets. First, the risk in question in the *Democratic Central Committee* decision is the risk associated with changes in the value of the asset, not the risk related to the operations of the Yellow Pages business and thus to the flow of imputation to local exchange service prices. Second, since the Telecommunications Act of 1996, all Washington telecommunications markets were opened to competition in law, and this Commission recently determined that these markets were open to competition, in fact.[26] Thus, even with imputation as currently practiced, customers of telecommunications services are not necessarily obliged to pay

[26] Comments of the Washington Utilities and Transportation Commission, Qwest Section 271 – Washington, WC Docket No. 02-189.

higher rates based on changes in the value of its assets deployed in the production of Yellow Pages services.

Q. DR. SELWYN AND DR. BLACKMON ASSERT THAT DEX'S YELLOW PAGES POSSESS A VALUE ASSOCIATED WITH NETWORK EXTERNALITIES AND A FIRST-MOVER ADVANTAGE. DO YOU AGREE?

A. Yes. Dr. Selwyn identifies the "Franchise Value" associated with the Yellow Pages operation with the combination of a first-mover advantage and network externalities,[27] by which he means the value derived from being the largest directory. Dr. Blackmon concurs.[28] It is certainly true that directories exhibit network effects in which one advertisement makes the book more valuable to readers and thus more valuable to other actual and potential advertisers. Thus, at any point in time, the largest directory will be able to command a premium price over smaller directories. In such a market, it is also true that the first mover will have at least a temporary advantage over other entrants.

Q. DOES THIS ADVANTAGE NECESSARILY ACCRUE TO THE REGULATED TELEPHONE COMPANY?

A. No. This component of the valuation of the Yellow Pages operation simply depends on size: the bigger the book, the more attractive it is to advertisers and the more useful it is to the "eyeballs" for which the advertising is intended. If the Seattle Times or Post-

[27] Selwyn, at pages 84-89.
[28] Blackmon, at page 9.

Intelligencer had decided to publish telephone directories with advertising in the late 19th century, it might have been their books that experienced the network externalities and first-mover advantage that Dex and its predecessors actually experienced.

Q. DO THESE ADVANTAGES IMPLY ANYTHING ABOUT A RATEPAYER ENTITLEMENT TO THE PROCEEDS OF THE SALE?

A. No. The first mover in this market was (what is now) Qwest Dex, and, as described in Mr. Grate's testimony, it built its Yellow Pages business long before the Washington regulatory authority regulated telecommunications services. Moreover, while regulation may have created a de facto monopoly for some telecommunications services, it never even attempted to confer an exclusive franchise on the Yellow Pages operation. Hence, it is not true that Qwest Dex's franchise value or first-mover advantage derived in any way from Qwest's predecessors' local exchange regulatory franchise.

Q. MR. KING ASSERTS THAT RATEPAYER ENTITLEMENT TO THE PROCEEDS OF THE SALE STEMS (AT LEAST IN PART) FROM THE CURRENT IMPUTATION OF YELLOW PAGES EARNINGS.[29] DO YOU AGREE?

A. No. The argument is circular. The mere fact that telephone ratepayers have received a large subsidy from the directory operations for a very long period of time does not, by

[29] Direct Testimony of Charles W. King, dated March 18, 2003 ("King"), at pages 14 to 15.

itself, give them an equity interest in the operations. One cannot derive an obligation to share proceeds of an asset sale from the presence of an earnings imputation.

Q. MR. KING ALSO ASSERTS THAT IF THE DIRECTORY OPERATIONS WERE TO INCUR LOSSES, THOSE LOSSES WOULD BE MADE UP BY TELEPHONE RATEPAYERS. DO YOU AGREE?

A. No. Mr. King asserts that

> Whenever a regulatory body issues a requirement for a utility to perform a function, there is an implicit obligation on the part of the regulator to permit the utility to recover all costs associated with that mandated function. Since the Commission requires directories, it would also be obliged to permit Qwest to recover all costs incurred in publishing those directories, even if they were not fully offset by directory revenues.[30]

First, while Qwest is obliged to publish directory listings, it is not obliged to engage in the local advertising business. Hence, even assuming the WUTC recognized Mr. King's "implicit obligation," the obligation does not extend to making up the losses of the directory operations. Second, it is unlikely that Mr. King's obligation would extend to offsetting directory operations losses through higher telephone prices. Finally, as discussed in the next section, the WUTC no longer has the ability to allow Qwest to recover losses from other competitive operations by raising telecommunications prices because telephone markets in Washington are open to competition.

[30] King, at page 15.

VI. CONTRIBUTION FROM DEX TO REGULATED LOCAL EXCHANGE SERVICES THROUGH TRADITIONAL IMPUTATION OR BY TREATING DEX SALE PROCEEDS AS REGULATED TELEPHONE COMPANY REVENUE IS INCONSISTENT WITH ECONOMICS AND PUBLIC POLICY.

Q. WHAT IS THE EFFECT OF IMPUTATION ON THE PRICES OF REGULATED TELEPHONE SERVICES?

A. In principle, imputation from the revenues of an unregulated affiliate to Qwest's rate-of-return-regulated services causes the revenue requirement to be lower than it otherwise would be. In turn, a lower revenue requirement, all else equal, results in lower prices for those services whose prices remain controlled by the rate-of-return regulatory mechanism.

Q. HOW HAS THE EFFECT OF YELLOW PAGES IMPUTATION CHANGED OVER TIME IN WASHINGTON?

A. Imputation has had an increasing effect on the prices of rate-of-return-regulated services. At the beginning of imputation in the 1980s, essentially all of Qwest's predecessor's telephone service prices were subject to rate-of-return regulation. Currently, less than BEGIN QWEST CONFIDENTIAL ********* END QWEST CONFIDENTIAL of Qwest's revenues come from such services. Because of competition and the reclassification of some of Qwest's services as competitive, every additional dollar of imputed contribution from Yellow Pages has over BEGIN QWEST CONFIDENTIAL ***** END QWEST CONFIDENTIAL times the effect on regulated service prices than it would have had if all services had remained classified as they

were in 1983.

Q. WHAT IS THE EFFECT OF IMPUTATION ON THE MARKETS FOR QWEST'S REGULATED TELCOMMUNICATIONS SERVICES?

A. Since the Telecommunications Act of 1996, national policy required that telecommunications markets be opened to competition, and the Act took specific steps to ensure that this would happen, requiring ILECs such as Qwest to sell competitors access to their networks. As of November 2002, more than a dozen CLECs have purchased over 130,000 unbundled, UNE-P and resold loops in Washington.[31] In addition, some CLECs serve customers using their own facilities. Recent trends show continued growth in CLEC lines in service. Following this entry and expansion of competitors, the WUTC acknowledged the presence of facilities-based competition in Qwest's local exchange markets in Washington (Docket Nos. UT-003022 and UT-003040), from which we conclude that the Washington local exchange market is fully opened to competition in the sense intended by Section 271 of the Telecommunications Act.

At the same time, nearly all of Qwest's retail services began to face competition from other wireline telecommunications providers like CLECs and interexchange carriers and from non-wireline suppliers of substitutes. Relying on existing and growing retail competition, the WUTC reclassified many services as competitive, including Centrex

[31] See Direct Testimony of Theresa A. Jensen, dated January 17, 2003, Confidential Exhibit TAJ-5C.

Features, Speed Calling, Intracall, Calling Cards, toll, toll operator surcharges, and directory assistance. In certain Washington geographic markets, high capacity circuits and business exchange services provided over them were reclassified as competitive.

The remaining Qwest cost-of-service-regulated telecommunications services face competition beyond that provided by wireline telephone companies. Cable companies currently provide cable modem service in competition with wireline DSL services and cable telephony in competition with local exchange and toll services. Wireless telephony continues to grow, and innovative flat-rate calling plans that combine local and toll service compete with wireline toll services. The net effect of these competitors—plus the effect of DSL services which substitute for second lines—has led recently to unprecedented absolute reductions in Qwest's access lines.

While the degree of competition faced by Qwest's remaining cost-of-service regulated services may be debated, the fact that their markets are opened to active competition is not. Failing to take this fact—and the national policy to encourage such competition—into account will harm telephone customers. Prices of these services are controlled by rate-of-return regulation which has no place when markets are opened to competition. Worse, whatever virtue rate-of-return regulation might have for setting prices for services subject to competition, under the policies recommended by Drs. Selwyn and Blackmon and Mr. King, telephone prices would be set below the level determined by rate-of-return regulation.

These policies would entail a literal subsidy from directory operations to cost-of-service-regulated local exchange services, and the efficiency consequences of subsidies are well-known in economics. Pricing a service below the incremental cost of providing it results in inefficient, excessive use of that service (customers buy it that would not be willing to pay the cost they impose on society by using it). In markets opened to competition, subsidization of a service discourages otherwise efficient firms from entering the market or expanding their operations. The result is a first-order loss in economic welfare, as potential entrants that have lower costs than the incumbent are prevented from entry, and a high-cost incumbent firm nonetheless is able to sell its services.[32]

From a public policy perspective, continued overt subsidies in telecommunications prices contradict the Telecommunications Act, which established competition as the mechanism for controlling prices and services in all telecommunications markets. The effect of continued imputation—or amortization of the Dex sales proceeds—is to reduce the Qwest price against which actual and potential competitors must compete. Entrants who rely on their own facilities or Qwest unbundled elements will find

[32] Economic welfare or economic efficiency is defined as the sum of consumers' and producers' surplus. Producers' surplus is simply profits. Consumers' surplus is the difference between what consumers are willing to pay and what they must pay for service. Prices in excess of marginal cost give rise to allocative inefficiency: welfare is lost on the difference between the amount consumed and the amount that would be consumed under marginal-cost based prices. Such efficiency losses are called "second-order" in economics because they are proportional to the distortion in demand resulting from the inefficient prices. Costs that are higher than marginal costs impose "first order" welfare losses on the economy because they entail losses on every unit of service that is consumed.

themselves with a smaller margin, as the retail price against which they compete is reduced by imputation (below what it otherwise would be), while the TELRIC-based price of the unbundled elements (and the actual cost of their own facilities) remains the same. This arrangement is not sustainable. It is inconsistent with the federal Act and is bad policy for telecommunications customers in Washington.

VII. ECONOMIC DISTORTIONS WOULD FLOW FROM THE PROPOSAL TO AMORTIZE THE SALE PROCEEDS OVER 15 YEARS.

Q. WHAT MECHANISMS ARE PROPOSED BY THE STAFF AND THE DOD/FEA REGARDING USE THE DEX SALES PROCEEDS?

A. Dr. Selwyn and Dr. Blackmon both argue that an amount in excess of the Washington portion of the total sales proceeds should be used "for the benefit of customers in Washington."[33] Dr. Selwyn defers to Dr. Blackmon as to the mechanism, recommending that the Washington share of the proceeds "be flowed through to ratepayers via the methodology described forth by Dr. Blackmon."[34] Dr. Blackmon does not propose a specific mechanism, but suggests:[35]

- that while Qwest might not need the money today, it will be required in the long run to offset the loss of imputation;
- that Qwest should account for the funds as not supplied by investors so that Qwest would not be entitled to earn a return on the funds; and
- that a one-time credit might be given to current customers to offset ongoing risks from the Dex transaction.

[33] Blackmon, at page 26.
[34] Selwyn, at page 110.
[35] Blackmon, at page 26.

Mr. King is more specific. He takes the value of the ratepayer entitlement to be the sum of the full price of the Dex sale, less adjustments for Qwest-contributed assets and transactions costs. This entitlement would be returned to the ratepayer in two steps. Ten percent of the value would be returned more or less immediately through a bill credit. The remaining 90 percent would be established as a regulatory liability and amortized over 15 years.[36] In his testimony, Mr. King states that this second step would take place in a future rate case.[37] However, from his interrogatory responses, it appears that Mr. King would calculate an annual customer credit as the sum of (i) a 15-year write-off of the entitlement and (ii) earnings at 9.367 percent on the (declining) balance of the entitlement.[38]

Q. WHAT ARE THE ECONOMIC EFFECTS OF MR. KING'S PROPOSAL?

A. The major economic problem with Mr. King's proposal is that it ignores the primary functions of prices in a market economy: to lead buyers and sellers to an efficient disposition of scarce resources as if by an invisible hand. Nothing in Mr. King's proposal actually reduces the cost of basic exchange service today and increases it tomorrow; nonetheless, consumers and potential competitors would be sent signals as if this were the case. Entry by otherwise efficient firms would be delayed, and the

[36] King, at pages 6 to 7.
[37] King, at page 5.
[38] Attachment to DOD/FEA's Response to Qwest Data Request III-36b.

balance of technological choices among consumers and suppliers of wireline, wireless, cable and satellite services would tilt temporarily towards wireline.

A second problem is that Mr. King's plan assumes that slightly over $1 billion can actually be taken out of Qwest's wireline local exchange business over a 15-year period without causing financial harm to Qwest. In the current economic climate, prospects for investment in wireline telecommunications are not bright. Demand volumes have stopped growing and in some cases are actually falling. Wireline networks are experiencing excess capacity. Many small telecommunications firms have gone bankrupt, and equity valuations throughout the industry have plummeted. Even if Mr. King's logic were correct, imposing a financial obligation of this magnitude on Qwest's rate-of-return-regulated services is fraught with risk.

Finally, Mr. King's plan "front-loads" the so-called benefits to ratepayers by reducing residential basic exchange rates in Washington today with the understanding that if nothing changed to disrupt the plan, basic exchange rates would be higher than otherwise after 15 years. Surely no one expects that a significant portion of Qwest's revenue will derive from regulated services in 15 years, nor that at the end of the period, there will be monopoly services which can support profitable rate increases. During the next 15 years, communications technology will undergo radical change, stemming from such predictable current alternatives to traditional wireline services as wireless, cable

and voice-over-internet-protocol services. Reducing prices below cost today with the expectation of raising them in the future is poor public policy.

VIII. CONCLUSIONS AND RECOMMENDATIONS.

Q. WHAT DO YOU RECOMMEND THE COMMISSION DO WITH RESPECT TO THE PROPOSED DEX TRANSACTION?

A. First, all of the information available implies that QCI received fair market value in this transaction. The structure of the transaction was designed to elicit the highest price qualified buyers were willing to pay, and the results are consistent with analysts' expectations. The Commission should reject claims that the sale failed to yield a fair market price for Dex.

However, whether QCI received a fair price is not at issue in the Staff's testimony. Despite Dr. Selwyn's lengthy calculations, at the end of the day, he recommends using—not some estimate of the fair market value—but the implicit value of current imputation, growing each year forever. Dr. Blackmon recommends using the sales price plus some portion of the amount he characterizes as a regulatory set-aside. Neither of these proposals depends on or makes any reference to differences between the realized Dex price and analysts' estimates of Dex's fair market value.

Second, continued reliance on subsidies and rate-of-return mechanisms like imputation is poor economics and poor public policy in Washington where advertising and local

telephone markets are open to competition. Had the Dex transaction not occurred, it seems unlikely that imputation would continue unchanged forever, and recognizing that imputation might not last forever does not constitute harm to ratepayers. The Commission should reject policies that imply permanent imputation and that only make sense under a perpetual monopoly franchise controlled by rate of return regulation.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

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

EXHIBITS

OF

WILLIAM E. TAYLOR

ON BEHALF OF

QWEST CORPORATION

April 17, 2003

INDEX OF EXHIBITS