Exhibit T-___ (GB-T-1)
Docket No. UT-021120
Witness: Glenn Blackmon, Ph.D.

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	DOCKET NO. UT-021120

DIRECT TESTIMONY OF

Glenn Blackmon, Ph.D.

STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

March 18, 2003

Revised May 14, 2003

Q. Please state your name and business address.

A. My name is Glenn Blackmon, Ph.D., and my business address is 1300 South Evergreen Park Drive Southwest, P.O. Box 47250, Olympia, Washington 98504. My business e-mail address is blackmon@wutc.wa.gov

Q. By whom are you employed and in what capacity?

A. I am employed by the Washington Utilities and Transportation Commission (Commission) as Assistant Director for Telecommunications.

Q. What are your education and experience qualifications?

A. I hold Ph.D. and master's degrees in public policy from Harvard University and a bachelor's degree in economics from Louisiana State University. I have been employed at the Commission since August 1995 and assumed my current position in April 1996. I previously served as the Commission's economics advisor in the interconnection case, UT-941464, and the U S WEST general rate case, UT-950200. Prior to working at the Commission, I was a consultant in private practice, where my clients included both regulated companies and consumer advocates, and an analyst for the Washington State Senate Energy and

Utilities Committee. I have presented testimony as an expert witness before this Commission, as well as the Illinois and Idaho commissions.

In my current position, I have testified before the Commission in various proceedings, including U S WEST's most recent general rate case (Docket UT-970766),

the GTE/Bell Atlantic merger case (Docket UT-981367), the Qwest/U S WEST merger

case (Docket UT-991358), the WorldCom/Sprint merger case (Docket UT-991991), the generic cost and price cases (Dockets UT-960369 and UT-003013), and the Qwest competitive classification of business services case (Docket UT-000883).

I am the author of a book, *Incentive Regulation and the Regulation of Incentives* (Boston: Kluwer Academic Publishers, 1994). I have authored or co-authored articles on utility regulation and economic theory published in *American Economic Review, Journal of Regulatory Economics*, *Yale Journal on Regulation*, *Journal of Risk and Uncertainty*, and *Public Utilities Fortnightly*.

Q. What is the scope of your testimony?

A. My testimony provides Staff's policy recommendation to the Commission. It also explains why the Commission's oversight of the regulated telephone company, Qwest Corporation (QC), is at the core of this case. My testimony shows that Qwest's stated basis for finding that this sale in the public interest – to forestall the bankruptcy of Qwest Communications International, Inc. – actually is no basis at all for approval of the transaction. I also provide the Commission with recommended conditions should it conclude that the transaction should be approved.

Q. Does Staff have other witnesses?

A. Yes. Dr. Lee Selwyn presents a detailed analysis of the proposed transaction. Kathy Folsom provides testimony on the financial effects of a real-world bankruptcy scenario analogous to the one Qwest claims would likely result if the Dex sale is disapproved.

Q. What is Staff's recommendation?

A. Staff recommends that the Commission find that the proposed sale of the Qwest Dex business is not in the public interest. Even with the so-called remedies proposed by Qwest, the transaction fails the test of no harm to customers, because it will lead to higher rates for customers. It should be rejected by the Commission.

Q. Please explain why Staff believes the sale is not in the public interest.

A. The Commission can look at this transaction at two levels and conclude, at either level, that the transaction is not in the public interest. At the customer level, the transaction is not in the public interest because it harms customers. The customers of Qwest Corporation would be better off if Qwest Corporation did not participate in this transaction than they would be if Qwest Corporation did participate as proposed. Qwest makes no credible claims to the contrary; at best, its testimony would support only the proposition that there is no *immediate* harm to customers. Qwest pointedly does not say that rates will not go up as a result of this transaction, only that the company is not proposing an increase *at this time*. Its offer is to insulate customers from the loss of imputation for a few additional years, after which time customers would surely be better off had the transaction not occurred.

The Commission can also take a broader view of this transaction, in terms of its effect on the ability of the Commission to protect captive customers and promote fair competition. At this level, the transaction is not in the public interest because it violates a fundamental public policy that the services of captive customers should not be used to subsidize competitive ventures or insulate companies from competitive risks. The Commission should not permit Qwest Corporation to be used in this way by its owner.

Q. Why do you refer to Qwest Corporation specifically in this answer?

A. I do so because Qwest Corporation is the corporate entity that is the focus of the Staff's analysis, attention, and concerns in this proceeding. It is incumbent local exchange telephone company that the Commission regulates under Title 80 RCW. It was known as U S WEST Communications, Inc., before its parent, U S WEST, Inc., was acquired by Qwest in 2000. Our interest in the actions of Qwest's ultimate parent, Qwest Communications International, Inc. (QCII), arises directly from the effect of those actions on the regulated company and its customers.

Q. If Staff is concerned only with Qwest Corporation, why does it oppose a sale to which Qwest Corporation is not a party?

A. Staff opposes the transaction because QC is an indirect party to the transaction and would be compelled to take actions that would be inconceivable if it were a standalone company with separate management and board of directors. The nominal transaction – QCII's disposition of Qwest Dex Holdings, Inc. – is of virtually no interest to Staff. We would have no objection to QCII's exit from the directory publishing business. However, that is not the core of the transaction that is now proposed by Qwest. The core element of what is commonly referred to as the Dex sale is actually found in two side agreements to which QC is a party. These agreements are long-term (40 and 50 years) agreements in which QC would agree to designate the buyer as its official directory publisher and not to publish a telephone directory itself or using another directory publisher. In other words, QCII will cause a corporation that it owns and controls to enter into agreements that provide no compensation to that corporation and that are clearly not in that corporation's best interest. QC sacrifices hundreds of millions of dollars in potential revenues every year into the future, and in return, QCII gets $7.05 billion in cash.

Q. Are you suggesting that Qwest is not really divesting itself of a standalone business enterprise?

A. Yes. As is demonstrated by the many side agreements associated with the purchase and sale agreement, Qwest will continue to be intimately involved in the directory publishing business. The main point of Qwest witness Burnett's testimony seems to be that nothing changes as a result of this transaction. In one sense, this is reassuring, because it is hard to imagine that the directory operation could be separated from the phone company without destroying its value to advertisers and telephone customers. However, it also illustrates how little there is to this so-called sale of Qwest Dex. Rather than selling a business, Qwest is simply securitizing its future directory revenues. The "buyer" is not a publisher but rather a financier who is supplying off-book financing to reduce the apparent debt levels of Qwest, and in the process Qwest loses the right to future directory revenues.

Q. Could the Commission allow the Dex sale itself to proceed but prohibit Qwest Corporation from entering into the publishing agreement and the non-compete agreement?

A. Yes, it could, except that if the Commission removes QC from the transaction, there is nothing left to the transaction. The buyer and seller have acknowledged that this transaction requires the QC agreements as well. The purchase and sale agreement is explicitly conditioned on the QC agreements. Even though the regulated company is not a party to the transaction, it is at the core of the transaction.

Q. Qwest claims that customers benefit from this transaction because they avoid the risk that the directory business will decline in value in the future. Do you agree?

A. No. The assertion that the directory business will decline in value is directly contradicted by **the analyses that the buyer and seller independently developed before they agreed to the sale**. The evidence on this point is presented by Dr. Selwyn. It should be obvious that the buyer does not believe this is realistic, despite Mr. Kennard's testimony to the contrary, because they agreed to buy the business. It is more plausible to think that the seller, Qwest, believes it, except that **the valuation studies prove otherwise.** Moreover, Qwest has never suggested that it is selling because conditions are right for a sale, i.e., that in some sense this is a seller's market for directory businesses. Qwest is attempting the sell the business now only because it is operating under an extremely short planning horizon driven almost entirely by its debt service requirements.

Q. Qwest witness Burnett testifies that advertising revenues from non-QC customers have increased from 0.1 percent to 30 percent. Does this suggest that Qwest's competitive position in the directory business is slipping?

A. No. Indeed it suggests just the opposite. QC's loss of market share in the local exchange telephone market apparently is not being matched by a loss of directory advertising business. Even when businesses go elsewhere to obtain their local telephone service, they still go to Qwest Dex for telephone directory advertising. This is entirely consistent with the presence of network externalities in the directory publishing business, which Dr. Selwyn discusses in his testimony.

<u>**The risk of bankruptcy is not a valid reason for approval of the Dex transaction.**</u>

Q. Qwest suggests that the sale should be approved in order to avoid bankruptcy. Is this a reasonable basis for Commission approval of the sale?

A. No, not in this case.

Q. Are there situations where it would be in the public interest for the Commission to impose a burden on customers in order to avoid bankruptcy?

A. Yes. There are situations where it is consistent with the public interest for the Commission to approve actions that impose immediate harm on customers but are necessary to avoid a greater harm in the long run. In some sense, that analysis lies behind every rate increase that a regulatory body ever approves:

The approved rate increase is a harm to customers, and yet it is nonetheless in the public interest because it maintains the long-term ability of the company to attract capital and provide service. The adverse consequences become more immediate and more apparent in circumstances where the viability of the regulated company is at risk. The Commission recently faced these circumstances in the electric industry. It approved a 25 percent emergency rate increase for Avista Utilities in 2001 in Docket UE-010395, saying the increase was "made necessary by extraordinary circumstances" relating to energy markets and supply shortages. Soon thereafter it denied emergency rate relief to Puget Sound Energy in Docket UT-011163 because the company did not show that failure to raise rates "would cause clear jeopardy to the utility or detriment to the ratepayers."

Q. Why do you distinguish between these electric utilities' request for emergency relief and Qwest's request to sell its directory business?

A. The electric utilities' emergency claims were based on financial conditions of the regulated utility itself and the concern that the utility would be unable to operate or raise necessary capital unless rates were raised to offset sharply higher power costs. By contrast, the financial problems that Qwest claims are solely problems of the *owner* of the utility rather than the utility itself. In addition, the relief being sought was an interim rate increase. By contrast, Qwest is proposing to convert a long-term revenue-generating asset into a one-time cash payment. Qwest's proposed solution does not fit the problem.

Q. Is it your understanding that sale of the Dex asset is either necessary or sufficient to avoid a bankruptcy filing by QCII?

A. No. I find Qwest's statements regarding potential bankruptcy to be inconsistent between its communication with the financial community and its communication with the regulatory community. Qwest executives claim in financial meetings that the company does not consider bankruptcy to be an option. At a financial conference on March 13, 2003, the company's chief financial officer spoke for almost an hour and never used the term "bankruptcy." The chief executive officer was widely quoted last fall as saying "the B word" has not been spoken in his presence by company executives. By contrast, the company's testimony here and in Utah suggests that bankruptcy can be averted only if the Dex sale is approved. As Qwest witness Jensen puts it, "Without the entire sale, bankruptcy is likely."

The absolute risk of bankruptcy is difficult to assess and probably depends as much on overall conditions in the economy and in the telecommunications industry as it does on Qwest's own actions. However, I would not disagree with the claim that the *short-run* effect of a Dex sale is to reduce the risk of bankruptcy, because the sale provides a one-time increase in cash flow. On an ongoing basis, the sale does not improve cash flow or profitability. To the contrary, Qwest loses a large, stable, and likely growing profit center. Thus the *long-run* effect of a Dex sale is to increase the risk of bankruptcy. The transaction would preserve value for common shareholders in the near term, but it does not improve the company's long-term prospects as a *business enterprise*. Thus the Commission should understand that approval of the Dex sale might do nothing more than postpone the bankruptcy filing by QCII.

Q. Should the Commission distinguish between Qwest Corporation and Qwest Communications International, Inc., in evaluating the bankruptcy issues that Qwest raises in this proceeding?

A. Yes. Qwest's discussion of bankruptcy risk misses important distinctions between the publicly traded company, QCII, and the telephone operating company, QC. QCII is the ultimate owner of QC, but they are not the same company. Even if QCII were to seek bankruptcy protection, it is neither automatic nor even likely that QC would also declare bankruptcy. All of the financial problems of Qwest are the financial problems of QCII, and indeed probably the only reason QCII is not already in bankruptcy is that it happens to own an incumbent local exchange company that has thus far generated enough cash to keep QCII above water.

Q. The Qwest witnesses suggest that a bankruptcy filing by the parent company would hurt the telephone company and its employees. Please respond.

A. I believe that they greatly overstate the effect of a parent-company bankruptcy on the employees and customers of the operating telephone company. A bankruptcy filing would likely cause control of QCII to shift from its current stockholders to its current debt holders. The new owners would have a very strong financial incentive to continue operating QC, because QC is a profitable enterprise with a substantial value as a going concern. Indeed, QC might even be better off with its parent in bankruptcy.

Q. Please explain why QC might be better off with its parent in bankruptcy.

A. A bankruptcy filing by QCII could benefit QC in several ways. First, it could give QC access to the financial markets on much more reasonable terms than it has today. Ms. Jensen and Mr. Cummings testify at some length about how QC today must rely on QCII for external financing. QC has a junk bond rating because of, and only because of, its parent company. A bankruptcy filing would give QC a new owner, one without QCII's overloaded debt level. Second, QC operates today under the cloud of questionable ethical, legal, and accounting practices that surround its owner. A bankruptcy filing could remove this cloud. Third, a change in ownership of QC could help restore a long-term perspective on telephone company investment decisions. The current equity owners face such a high risk of investment loss due to bankruptcy that they can hardly be expected to invest for the long term.

Q. Should the Commission take extraordinary steps to avoid a bankruptcy in order to protect the employees of Qwest?

A. No. I can understand the concern of Qwest's employees about a bankruptcy. They have already suffered tremendous losses over the past couple of years, in terms of layoffs, lost investments, and less favorable employment terms.

However, a bankruptcy filing by QCII would not necessarily lead to further layoffs or spending reductions at QC and, as I discussed earlier, could even improve operating conditions at the telephone company. A bankruptcy filing likely would cause employees who have invested in QCII stock to lose money, but these losses arise in their capacity as stockholders rather than as employees. Other, much larger holders of Qwest stock would be the primary beneficiaries of any extraordinary effort by the Commission to protect Qwest employees. In particular, the founder of Qwest and the principal shareholder of QCII, Philip F. Anschutz, is the beneficial owner of about one-sixth of the company's common stock. At the current share price of about $4, he will avoid a loss of about $1.1 billion if the company succeeds in using the directory sale to avoid a QCII bankruptcy. ~~In comparison, stock purchases through the company's employee stock purchase plan over the last three years (1999 through 2001) amount to about 3 million shares. At a price of $4 per share, the potential loss on employee-purchased shares is only $12 million, or about 1 percent of Mr. Anschutz's potential loss.~~ <u>This is four times the potential loss that all the Qwest employees collectively face with a potential bankruptcy. Thus, for every dollar of employee-held shareholder value that might be preserved through any extraordinary</u>

measure to avoid bankruptcy, Mr. Anschutz would receive an additional four dollars.

Q. Should the Commission be concerned that in a bankruptcy proceeding the telephone company assets would be disposed of separately from the directory publishing assets?

A. No. Qwest witness Johnson appears to be making the argument that in a bankruptcy proceeding the telephone company would be sold off separately from the directory business. Apparently the argument is that in that scenario customers would not get even the short-term extension of imputation that Qwest is offering in this proceeding. In other words, it is better to take half a loaf than have no bread.

The flaw in that argument is that there is little or no economic value in the directory publishing business if it is separated from the telephone company. That point is proved in the purchase and sale agreement itself, which requires the commitment of the telephone company not to publish a competing directory. Thus separate disposition of the publishing company and the telephone company would be of little or no interest to the creditors who would seek to maximize the value of all the assets of a bankrupt Qwest.

Q. Can you point to any actual bankruptcy case that illustrates the points you have made?

A. Yes. The bankruptcy of Enron presents the Commission with an excellent opportunity to assess the possible consequences of a Qwest bankruptcy. As spectacular as Qwest's downfall has been – with the accounting irregularities, government investigations, criminal and civil charges, and stock price collapse – Enron's was significantly worse. Yet Enron owns a public utility, Portland General Electric, that has experienced none of the problems that Qwest claims await Qwest Corporation. Staff witness Kathy Folsom provides greater detail on this point.

Q. Please summarize Staff's analysis of the bankruptcy issue.

A. It is virtually impossible to know now whether QCII can avert or postpone bankruptcy by selling the directory business. It is even possible that the company could avoid bankruptcy without selling the directory business. However, if were established that the sale of the directory business were the only way to avoid a bankruptcy filing by QCII, the Commission should nonetheless disapprove the sale. The harm to customers and to the public interest would be smaller in a QCII bankruptcy scenario than in the scenario that Qwest offers in this proceeding.

<u>It would be bad public policy to allow QCII to prop up its other ventures using the QC directory publishing rights.</u>

Q. Earlier you said that the proposed transaction violates a fundamental public policy that the services of captive customers should not be used to subsidize competitive ventures or insulate companies from competitive risks. Please explain.

A. It is very important, as a matter of sound regulatory policy, that the Commission not permit companies that have both captive customers and competitive ventures to use their non-competitive services to support their competitive efforts. This principle is well established in state law and in the Commission's approach to telecommunications regulation, but we usually think of it in forward-looking terms. For example, all would agree that the Commission should ensure that companies are not using profits from non-competitive services to subsidize money-losing competitive services. However, it is equally applicable in the circumstance now before the Commission, where Qwest is attempting to use the directory revenues to cover its accumulated competitive losses.

Using the resources of QC, including the revenues associated with its directory publishing opportunities, to prop up QCII would amount to an unfair competitive advantage of the unregulated parent. There are many companies whose owners have been allowed to try and allowed to fail in the competitive arena. A partial list includes WorldCom, Global Crossing, Winstar, Covad, XO Communications, Fairpoint, Electric Lightwave, Advance Telecom Group, Avista Communications, Rhythms, NorthPoint, Jato, Teligent, and GST. QCII deserves nothing more than this same opportunity to try and to live with the consequences of its attempt.

Q. Are you saying that it is unfair to other competitors for QCII to protect itself by using assets from the regulated telephone company?

A. Yes, it is a question of fair competition. However, the problem goes well beyond any question of fairness to competitors. If the Commission were to permit QCII to cushion its fall by forcing QC to give away its directory franchise, the Commission would create a severe distortion in the risk-return calculus that companies in QCII's position should be expected to make. The distortion arises because QCII would be allowed to receive all of the upside benefits should a business venture prove successful but only pay a portion of the downside costs should that venture fail.

To illustrate this point with a very simplified example, assume the following:

- Qwest's management is presented with a decision about whether to build a global fiber optic network to supply an expected rapid growth in data transmission needs of businesses and consumers.
- The business opportunity will either succeed or fail, with equal likelihood.
- Success will bring Qwest a profit of $5 billion.
- Failure would bring Qwest a loss of $10 billion.

As presented, this is a business venture that Qwest should decline, because the expected gain is negative. The company has a 50% chance of making $5 billion and a 50% chance of losing $10 billion. Any regulatory regime that encouraged companies to take such ventures should be considered defective.

It is reasonable to believe that a corporation would decline such an opportunity if it would bear the full upside and downside potentials. However, the calculus of this example changes dramatically if Qwest is allowed to shift the downside costs. For example, assume that in the case where the outcome is failure, Qwest is allowed by regulators concerned about bankruptcy to recoup $7 billion of the loss. Now success still brings Qwest a profit of $5 billion, but failure brings a loss of only $3 billion. It is now quite reasonable to expect Qwest to take that business venture, even though it is fundamentally unsound and is attractive only because regulators created a distorted risk-reward choice for the company.

As this example illustrates, allowing companies to use their regulated operations as a cushion for risky competitive ventures is not just unfair to the competitors, it can be expected to lead to bad decisions. Corporate management will take risks that are not worth taking because they stand to enjoy all the upside potential and only a portion of the downside risk.

Q. Is there a general concern among regulators about the use of regulated resources to benefit unregulated parent companies?

A. Yes. This is a significant and growing concern to regulators. Indeed, state regulators identified the misuse of regulated company resources by affiliates as one of their major concerns at a "summit" of commissioners earlier this year. A recent executive briefing by the National Regulatory Research Institute, which helped facilitate the summit, reported:

> Kansas Corporation Commission stands firm on affiliate abuse…Federal Energy Regulatory Commission (FERC) follows Kansas lead…Kansas last fall prohibited shifting non-utility debt to a regulated utility…Since Enron collapse, fears of holding company abuses and their adverse effects on ratepayers and investor confidence continue to plague the energy industry…In a parallel case, FERC barred utility-backed debt from use in unregulated ventures…Regulators at NARUC/NRRI Commissioners Only Summit identified holding company and affiliate abuses as a major area of

> regulatory concern…With the possibility of PUHCA repeal, state commissions are questioning whether they have enough authority to deal with all forms of holding company abuse…such as upstream loans and the use of the utility as collateral… Without more transparent utility reporting…(which is up to the Securities and Exchange Commission)… investors are likely to remain skeptical of investments in the electric utility sector.
> http://www.nrri.ohio-state.edu/executivebriefings/

As the above discussion suggests, this concern is most often presented in terms of energy companies, due both to the greater prevalence of the holding company structure in that industry and to the publicity surrounding the Enron debacle. However, the concern also exists with Qwest, which is similar to the energy companies both in corporate structure and in volatile parent-company activities.

The Washington portion of the transaction can be disapproved separately from Qwest's directory publishing operations in other states

Q. Staff is recommending that the Commission disapprove the proposed sale of Dex. Is it realistic for a single state to take this action, considering the multi-state operations of Qwest?

A. Yes, it is quite realistic. The fact that Qwest operates in other states should not influence the Commission's independent decision on the proposed transaction. The Commission should make its decision based on the public interest in the state of Washington. If Washington disapproves the transaction, Qwest can make a business decision about whether to renegotiate the sale to exclude Washington. The buyer and seller have already broken the Dex operation into two completely separate sales. The first seven-state "Dexter" transaction has already closed and is in no way contingent on the close of the second "Rodney" transaction.

Moreover, even if Qwest were not allowed to sell the Washington piece of the business to the proposed buyers, Qwest Corporation could still contract with Dex and its new owners to publish the Washington directories. Staff would expect any directory publishing agreement, whether with Dex or with another publisher, to compensate Qwest Corporation fully for the economic value of the directory franchise.

Q. Under this approach, where QC negotiates a compensatory directory publishing agreement, would the current practice of imputation still be necessary?

A. No. Imputation today is necessary because Qwest assigns directory advertising revenues to a separate corporate entity, Qwest Dex. Those revenues are imputed to the telephone company, QC, for ratemaking purposes. If the Commission disapproves the proposed transaction and returns the directory publishing function to QC, the directory advertising revenues would once again be received by the telephone company itself. Imputation would no longer be necessary or appropriate.

<u>If the Commission approves the proposed sale, it should do so only with stringent conditions to protect the interests of Washington customers</u>

Q. Please explain why Staff is offering proposed conditions to the sale, given its opposition to the sale itself.

A. As Staff to the Commission, we believe that we have an obligation to present the Commission with a range of options. These conditions would mitigate the harm to the public interest from this sale. Staff has concluded that even with these conditions the sale would not pass the public interest test, but we realize that the Commission's judgment may differ on that point.

Q. What are Staff's recommended conditions should the Commission approve the Dex sale?

A. First, the Commission should require that QCII and QC enter into a contract in which QCII, as recipient of the proceeds of the transaction, compensates QC each year for the expected amount that QC could otherwise realize from the directory publishing function. This contract should remain in place for as long as either Publishing Agreement or the Noncompetition Agreement is in effect. The contract should specify that no amendments are permitted without Commission approval and that the contract continues even if the current relationship between QC and QCII changes. The specific annual amounts are shown in Exhibit ____ (GB-2C)

The QCII-QC contract mechanism permits QCII to use the proceeds of the sale transaction to reduce its debt, which is its stated reason for wishing to sell the directory business. It provides customers of QC with some protection from future rate increases, since the regulated utility would continue to receive payment as if it had not given up its right to be in the directory publishing business. This is appropriate because it is the QC publishing and non-competition agreements that create the value in this transaction. In calculating the Washington portion, the Commission should reject Qwest's various proposals to retain portions for itself, as is explained further in Dr. Selwyn's testimony.

Second, the Commission should require that, in addition to the contractual payments proposed above, QCII provide Washington customers with a one-time payment to compensate them for the additional risks that QCII has created for customers of QC. Staff recommends a one-time payment equal to 10% of the net proceeds from the Washington state portion of the sale. The specific amount is set out in Exhibit ____ (GB-2C). Both the annual payment and the one-time payment should be treated as operating revenues of QC for all regulatory purposes, including financial reporting and calculation of regulatory fees. The one-time credit can be funded using money that Qwest reserved for securing regulatory approvals. This money arises from Section 5.4(b)(ii) of the purchase and sale agreement; the provision requires QCII to consent to regulatory conditions with a financial impact of up to $500 million. (Staff would normally treat the dollar amount as confidential since it is stated in a "confidential letter of understanding," but Qwest has publicly disclosed the amount.)

Third, the Commission should impose additional safeguards to protect QC and its customers from the ongoing financial risks of QCII's other enterprises. As I discussed earlier, the long-term effect of this transaction will be to increase the financial risk of QCII. That risk should not be absorbed by QC or its customers. At a minimum, the Commission should require, as a condition of its approval of the Dex sale, that Qwest Corporation be prohibited from taking any of the following actions until it first obtains an order of the WUTC finding that the action is in the public interest:

a. Increase the debt-to-equity ratio in Washington above the October 2002 level of 48.32%.

b. Increase the dividend of QC to its common stock holder from the level paid in 2002.

c. Lend cash or otherwise provide credit to QCII or any affiliate of QCII other than QC.

Fourth, the Commission should require that any changes to the publishing agreement and any other agreement involving QC be made only with the Commission's approval. These agreements are the instrument by which QC complies with its regulatory obligations to publish a directory, provide listings on a nondiscriminatory basis, and comply with other requirements. Moreover there are elements of the directory that, while not required by regulators, nonetheless provide benefits to businesses and consumers. Those elements should be protected by requiring Commission approval of any changes in the agreements.

~~A. First, the Commission should require that the entire portion of the proceeds attributable to Washington state directory operations be paid to Qwest~~

~~Corporation. This is appropriate because it is the QC publishing and non-competition agreements that create the value in this transaction. In calculating the Washington portion, the Commission should reject Qwest's various proposals to retain portions for itself, as is explained further in Dr. Selwyn's testimony.~~

~~Second, the Commission should require that QCII supplement the Washington state share of the sale proceeds with additional funds from the sale, using part of the $500 million that QCII has reserved for securing regulatory approvals. As Dr. Selwyn explains,~~ **~~the sale price is lower than either the full business enterprise value of Dex or the net present value of expected future imputation benefits~~**. ~~Attributing to customers all proceeds of the sale therefore falls short of holding customers harmless from the sale. The harm to customers can be reduced by using the money that Qwest reserved for securing regulatory approvals. This money arises from Section 5.4(b)(ii) of the purchase and sale agreement; the provision requires QCII to consent to regulatory conditions with a financial impact of up to $500 million. (Staff would normally treat the dollar amount as confidential since it is stated in a "confidential letter of understanding," but Qwest has publicly disclosed the amount.)~~

~~Third, the Commission should require that QC use these proceeds – both the state share of the sale proceeds and the additional money reserved for regulatory approvals – for the benefit of customers in Washington. QC may not have an immediate need for this cash, given the generally good financial condition of the telephone company, but the cash will be required over the long run to offset the loss of ongoing imputation benefits. QC should be required to account for these funds on its regulated books to recognize that they are not supplied by investors and that Qwest's stockholders are not entitled to a return on the funds. The Commission may also wish to consider requiring a one-time credit to customers to compensate them for the ongoing risks they will face as a direct result of QCII's disposal of its directory business.~~

~~Fourth, the Commission should impose additional safeguards to protect QC and its customers from the ongoing financial risks of QCII's other enterprises. As I discussed earlier, the long-term effect of this transaction will be to increase the financial risk of QCII. That risk should not be absorbed by QC or its customers. At a minimum, the Commission should (1) prohibit QC from increasing its debt-to-equity ratio above the present level and (2) require that QC obtain Commission approval before paying any dividend to its owner.~~

~~Additional safeguards may be necessary and should be investigated in a separate proceeding.~~

~~Fifth, the Commission should require that any changes to the publishing agreement and any other agreement involving QC be made only with the Commission's approval. These agreements are the instrument by which QC complies with its regulatory obligations to publish a directory, provide listings on a nondiscriminatory basis, and comply with other requirements. Moreover there are elements of the directory that, while not required by regulators, nonetheless provide benefits to businesses and consumers. Those elements should be protected by requiring Commission approval of any changes in the agreements.~~

Q. If the Commission were to conclude that the "no-harm" standard was otherwise satisfied, would it still be appropriate for the Commission to require that QCII use its $500 million regulatory set-aside to compensate customers?

A. Yes, it would, for the simple reason that Qwest is prepared to compensate customers up to this amount. Even if the Commission concludes that this transaction should be approved, it still should protect the interests of customers. In the first instance, that means ensuring that customers are not harmed by the transaction. Once the Commission has done that, it should still acknowledge that Qwest has explicitly set aside money that is available for the benefit of customers. Qwest approaches the regulatory process surrounding this transaction with a very businesslike, even cynical attitude, and there is no reason for the Commission to be any less protective of the interests of customers. The chief financial officer of Qwest recently told investment analysts that regulatory approvals were being secured at lower cost than anticipated. He noted, for example, that Qwest gained approval in Utah for a one-time cash payment to customers of $22 million. That leaves $478 million remaining in the regulatory set-aside, with only Washington and Arizona remaining. Since Qwest is willing to pay this amount, refusing to accept it would constitute a harm to customers.

Q. Would it be sufficient to protect the interests of customers for the Commission to order continued imputation of the current level of directory revenues?

A. No. Locking in the current level of imputation, even for the full life of the publishing agreement and the non-competition agreement, does not meet the no-harm test. As Dr. Selwyn explains, customers can reasonably expect the value of imputation to rise with growth in the business, and the nominal value will rise with inflation. Moreover, a simple requirement to continue imputation would be like unsecured debt: The next financial turmoil at QCII or some unknown future owner could prompt a default. The interests of customers are adequately protected only if there are specific safeguards as I have suggested.

Q. Does the Commission have the option of continuing imputation of actual directory revenues as received by the new owner?

A. Imputation of actual directory revenues is an option, though it probably is not a satisfactory option for addressing the lack of compensation to QC in this transaction. Imputation is an option because the new owner of Dex would be an affiliate of Qwest Corporation under Washington law. Qwest's application characterizes the buyer, Dex Holdings LLC, as a non-affiliate, but this is not accurate. Similarly, Qwest witness Jensen testifies that the sale "terminates the QC affiliate arrangement between QC and Dex through the sale of the directory publishing business to the Buyer, which is not part of the Qwest family of companies." (Jensen direct, p. 5) Ms. Jensen may be correct about the buyer being outside the family, but common control or ownership is not the only basis for an affiliate relationship under Washington law.

In this instance, the new owner's status as an affiliated interest results from the publishing agreement and other agreements with Qwest Corporation.

Washington law, specifically RCW 80.16.010, provides that an affiliated interest exists between a public service company and any person or corporation that has a management or service contract with the public service company. Since the buyer would be an affiliate, the Commission could examine its books and records just as it can today examine the books and records of Qwest Dex. The Commission therefore would have access to the information necessary to determine the actual directory revenues of the new owner and could impute those revenues to Qwest Corporation for ratemaking purposes. Qwest Corporation would be required to provide the publisher's financial results as part of its annual affiliated interest report. Moreover, the publishing agreement itself would be an affiliated interest arrangement. Under RCW 80.16.020 the Commission could investigate any proposed change to the publishing agreement and disapprove the change if it is not in the public interest.

However, as Dr. Selwyn explains, continued imputation would likely undermine the financial integrity of QC. Today substantial amounts of cash pass between QC and QCII, in the form of cash to QC for capital spending and cash from QC as dividends. Within those transactions Qwest can readily accommodate the imputation of directory revenues. There would be no such cash transfers between Qwest and the new owners. Imputation of directory revenues would simply mean less revenue for QC. Therefore, recognition of the affiliate interest between QC and the new owners is important as a basis for the Commission's continuing oversight of the publishing agreement, but it does not provide a practical basis to continue imputation of the actual directory revenues to QC.

Conclusion

Q. No further questions.

A. Thank you.