Exhibit T-__(LLS-25ST)

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**

Supplemental Direct Testimony

of

LEE L. SELWYN

on behalf of the

Washington Utilities and Transportation Commission Staff

May 21, 2003

REDACTED

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THE PARTIAL SETTLEMENT AGREEMENT

Introduction

Q. Please state your name, position and business address.

A. My name is Lee L. Selwyn. I am President of Economics and Technology, Inc. ("ETI"), Two Center Plaza, Boston, Massachusetts 02108.

Q. Have you previously submitted direct testimony in this proceeding?

A. Yes, I submitted prefiled direct testimony in this proceeding on March 18, 2003.

Q. What is the purpose of your testimony at this time?

A. The purpose of this testimony is to address the partial settlement that was entered into by Qwest Corporation ("QC"), Des Holdings, L.L.C., the Department of Defense, AARP, Public Counsel and WeBTEC on May 16, 2003, and specifically to respond to the testimony filed in support thereof by Mr. Reynolds, Mr. Kennard, Mr. Brosch and Mr. King.

As presented, the proposed settlement does not satisfy the Commission's guidelines covering the sale of utility property, and thus should not be adopted.

Q. Does Staff support the proposed settlement as presented by the settling parties?

A. No. Staff does not believe that the proposed settlement comes even close to satisfying the specific requirements that the Commission has adopted, most recently in Docket No. UE-990267 (the *Colstrip* case) with respect to the sale of utility assets, and as such is not in the public interest. The specific bases for Staff's conclusions are addressed both by myself and by Dr. Blackmon.

Q. Please summarize the guidelines that were adopted by the Commission in *Colstrip*.

A. *Colstrip* provides four specific guidelines, three of which are directly applicable to the proposed sale of Dex:

(1) No ratepayer harm:

> The transaction should not harm ratepayers by causing rates or risks to increase, or by causing service quality and reliability to decline, compared with what could reasonably be expected to have occurred in the absence of the transaction.

(2) Balance interests of all stakeholders:

> The transaction, with conditions required for its approval, should strike a balance among the interests of ratepayers, shareholders, and the broader public that is fair and that preserves affordable, efficient, reliable, and available service.

(3) Maintain competitive neutrality

> The transaction, with conditions required for its approval, should not distort or impair the development of competitive markets where such markets can effectively deliver affordable, efficient, reliable, and available service.

Q. Mr. Reynolds maintains that the proposed settlement satisfies all three of these guidelines. Do you agree:

A. No, I do not. In fact, the terms of the settlement are directly at odds with the guidelines in a number of material respects.

The proposed settlement harms ratepayers.

Q. In what respects does the proposed settlement fail to satisfy the "no harm to ratepayers" guideline?

A. The settlement proposes to replace the existing imputation of directory publishing profits with a new "annual revenue credit" device that would constitute a "known and measurable change" that would be used for ratemaking purposes as a credit toward QC's intrastate revenue requirement. The annual revenue credit would be frozen at $110-million for the first four years and then would be reduced and frozen at $103.4-million for the next eleven years, after which it would cease to be applied altogether. The existing imputation, by contrast, increases over time to reflect the growth in Washington directory publishing profits, and under existing rules is to continue indefinitely into the future. Hence, the settlement both limits the amount of the credit and truncates its applicability beyond the initial fifteen years. Dr. Blackmon has estimated the present value of the existing imputation arrangement at BEGIN QWEST CONFIDENTIAL << >> END QWEST CONFIDENTIAL and the present value of the reduced and ultimately truncated revenue credit at $807-million, resulting in a loss to QC of BEGIN QWEST

CONFIDENTIAL << >> END QWEST CONFIDENTIAL Offsetting this BEGIN QWEST CONFIDENTIAL << >> END QWEST CONFIDENTIAL loss will be a one time "bill credit" of $67-million hence, the net cost to Washington ratepayers, in present value terms is BEGIN QWEST CONFIDENTIAL << >> END QWEST CONFIDENTIAL

Q. Why do you describe this as a "cost" to Washington ratepayers?

A. All else being equal, the reduction and ultimate elimination in the amount of yellow pages contribution will have the effect of increasing the revenue requirement for all other QC intrastate services, resulting in rates that are higher than they would otherwise be by an amount that is roughly comparable to the reduction in the yellow pages contribution.

Q. You seem to be making a distinction between the existing "imputation" arrangement and the annual revenue credit that is being proposed in the settlement. How do these mechanisms differ, and why is that difference germane to the Commission's consideration of the proposed settlement?

Q. The current practice of "imputing" Washington directory publishing profits as part of QC's intrastate revenues represents what amounts to an accounting adjustment within the overall QCII corporate structure. Qwest operates its Washington directory publishing business out of a separate affiliate, Dex, and records the revenues and profits that it generates therefrom on Dex's books. This Commission has determined that it considers the Washington directory publishing activity to fall within the scope of QC's regulated operations in

Washington, and thus treats the revenues and profits that are being recorded on Dex's books *as if* they were being earned and recorded on QC's books. While QC may disagree with that treatment, the revenues and profits being generated from the publishing activity are real and can be used internally by Qwest to, in effect, "fund" the imputation.

Once the sale of Dex has been completed, there will no longer be real or actual cash revenues or profits flowing to Qwest; they will instead flow to Dex Holdings, L.L.C., which will have no common ownership with QC. Accordingly, no "transfer" or shifting of revenues and profits between QCII entitles will be possible, and thus no "imputation" of such revenues and profits into QC can take place. The proposed "revenue credit" apparently attempts to *simulate* the effects of an imputation, but because it is not backed up by actual revenues and earnings, effectively represents a net decrease in actual QC earnings.

Q. Why is that important?

A. Several reasons. First, the decrease in QC revenues and earnings might impair QC's ability to attract capital and could result in a higher cost of capital for the Company in the future. One consequence of that might be an increase in the Company's cost of capital. Should that occur, the higher cost of capital could offset, eclipse, or perhaps even exceed the amount of the "revenue credit" and, as such, eliminate or even reverse its ostensibly salutary impact upon QC's rate level. If QC cannot attract capital on reasonable terms, the state's telecommunications network and overall economy will suffer.

Second, in the event that QCII ultimately files for bankruptcy notwithstanding the immediate infusion of cash following the sale of Dex, the status of the "revenue credit" is entirely unclear. For example, the bankruptcy court might treat QC as simply another QCII creditor, and afford the "revenue credit" the same status as any other unsecured QCII debt. Alternatively, the bankruptcy court could potentially ignore the "credit" altogether as constituting nothing more than an unenforceable intracompany transfer commitment. Note that I am not offering any sort of legal opinion as to the actual status of this "revenue credit" in the event of QCII bankruptcy, but would observe that its status is clearly highly questionable at best.

Q. In that regard, does the proposed settlement and the sale of Dex that it would then facilitate provide any assurance that QCII will avoid bankruptcy?

A. No. As Dr. Blackmon discusses in more detail, while the cash that will be produced by the sale of Dex will perhaps avoid the immediate prospect of QCII bankruptcy, bankruptcy in the not-too-distant future remains a real possibility. In that event, however, QCII will not have any "quality asset" like Dex to sell as a means for raising short-term cash.

Q. Would QCII be selling Dex were it not for its current financial distress?

A. No. Indeed, this very point was emphasized by Mr. Kennard on May 19 in response to a question by Commissioner Hemstad. Mr. Kennard was asked whether he, were he CEO of a "stable" RBOC, would sell off its directory publishing business. Mr. Kennard responded that he would not.

Q. Have the settling parties adequately addressed the specific concerns that you have enumerated here in their defense of the proposed settlement?

A. No, they have not. The settling parties appear to have focused solely upon the immediate results of the proposed settlement – from QC's perspective, the replacement of its current imputation requirement with the reduced and truncated "annual revenue credit," and from the consumer parties' perspective, the immediate $67-million cash refund that they are to receive. In so doing, they have essentially ignored the long-term consequences for QC's rates and for QC's financial health. The one-time $67-million payout to ratepayers hardly compensates for the BEGIN QWEST CONFIDENTIAL << >> END QWEST CONFIDENTIAL loss in directory publishing contributions that are to be foregone under the proposed settlement. The sale of the "quality asset" (Dex) may raise immediate cash for the parent QCII, but will permanently remove a critically important source of financial strength for QC.

The proposed settlement primarily benefits QCII shareholders and thus fails to strike the required balance among the interests of ratepayers, shareholders and the public.

Q. Will the settlement "strike a balance between the interests of ratepayers, shareholders, and the broader public that is fair and that preserves affordable, efficient, reliable and available service" as required by the Commission's guidelines?

A. No. The settlement would provide only the most limited benefit to ratepayers (the $67-million one-time bill credit) while exposing ratepayers to considerably higher rates in the future as well as to the consequences of an unfunded and possibly unenforceable "revenue credit" that is far less in amount, far shorter in duration, and far less certain than the existing imputation.

Significantly, the specific reason that Judge Harold H. Greene had awarded the directory publishing business to the BOCs rather than to AT&T at the time of the Bell System break-up was to maintain "affordable" telephone service. Removing the yellow pages contribution will clearly compromise QC's ability to provide affordable telephone service in the future. Additionally, because the "revenue credit" will be unfunded, QC's ongoing ability to provide efficient and reliable service could also be impaired. QC's Washington ratepayers in no sense caused or created QCII's current financial crisis. "Fairness" in this instance thus requires that QC ratepayer interests take precedence over QCII shareholder interests. QCII will realize an enormous gain from the sale of Dex. Under the settlement, however, not only will none of that gain be shared with QC ratepayers, QC ratepayers will be made worse off than they would be had the sale not taken place. There is hardly any "balance" here, and if adopted the settlement will expose QC, its ratepayers, and the broader public to serious risks with respect to the affordability, efficiency, reliability and availability of telephone service in Washington.

The proposed settlement is not competitively neutral.

Q. Mr. Reynolds argues that the elimination of the "revenue credit" after fifteen years benefits competition in Washington because it "is not an endless subsidy that has the potential to distort or impair the development of competitive markets indefinitely." In discussing the settlement during his cross-examination on May 19, Mr. Kennard characterized the yellow pages imputation as an "artificial subsidy." Does the contribution from QC's directory publishing operations constitutes an "artificial subsidy"?

A. No. First, no "subsidy" can be said to exist unless it enables a service to be priced below long run incremental cost, and there is no Qwest service that has been shown to be priced below this cost standard. In its 15th Supplemental Order in Docket No. UT-950200, this Commission specifically rejected USWC's contention that residential service was being "subsidized," and found instead that no such subsidy exists:

> 8. USWC argues that under the Telecom Act, universal service may only be subsidized on an equitable and nondiscriminatory basis, and imputing income to USWC is improper because there is no evidence subsidies are needed by all customers including those who may be millionaires.
>
> The Commission rejects this argument. The proposal is not a universal service subsidy. It is a ratemaking adjustment. Its purpose is to reflect funds that would be available to the Company, but for Company action. In any event, the Commission finds in this Order that existing rates for local exchange service do cover incremental costs of providing that service, which thus needs no "subsidy," and the Commission does not attribute or "earmark" the directory imputation directly to any class of customers. Therefore, the subsidy argument is inapposite.[1]

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1. Docket No. UT-950200, 15th Supplemental Order, 169 PUR 4th 417, 445 (1996), *Aff'd, US West Communications, Inc. v. Washington Utilities and Transportation Commission,* 134 (continued...)

Second, there is nothing “artificial” about using the profits from directory publishing to support the common costs of the overall local exchange carrier’s operations. The publishing of telephone directories derives massive economic benefits from the presence of affordable, efficient, reliable, available and universal local telephone service. This natural synergy between the local exchange telephone business and the telephone directory publishing business has been the principal source of Dex’s ability to set and to maintain directory advertising rates that are many multiples of Dex’s costs. As Murray Devine has recognized in its FAS 141 valuation of Dex East (Exhibit 243), no competing yellow pages publisher that is not the “official” ILEC directory publisher is able to set its advertising rates anywhere near as high as Dex is able to do, and no competing publisher that is not the “official” directory publisher is anywhere near as profitable as Dex. The flow of some portion of the value, whose existence is intimately and integrally linked to that ILEC’s local telephone operations, is not a “subsidy” by any reasonable definition, and is certainly not an “artificial subsidy” as Mr. Kennard has suggested.

Q. I would like you to accept, solely for purposes of discussion, that the yellow pages imputation *is* a subsidy and that its continued existence impairs competition, as Mr. Reynolds and Mr. Kennard have suggested. Does the proposed settlement resolve that concern?

A. No. First, profits from directory publishing represent only one of several existing sources of contribution toward the common costs of ILEC operations that help to keep the price of local

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1. (...continued)
Wn.2d 74, 99, 949 p.2d 1337 (1997).

exchange access lower than it would otherwise be. The other sources include the above-cost pricing of switched access and intraLATA toll services, vertical features, and the various state and interstate universal service and high-cost funding mechanisms. Elimination of the contribution from yellow pages would not cause below cost services to be priced above cost. Rather, it would cause services that are already priced above cost to be priced even more above cost. To the extent that an above-cost price is imposed for an essential service, such as switched access, that is an input to telecommunications services that are furnished by competing carriers, competition is impaired by increasing the competitors' costs and by suppressing consumer demand. Were these support mechanisms eliminated, the prices of these essential services and discretionary service features would be reduced, a result that would increase economic efficiency overall, enhance competition, and provide substantial consumer benefit in the form of lower prices and increased competition. By contrast, the prices that Dex charges for yellow pages advertising are unlikely to be reduced if, for example, Dex were no longer required to make any contribution of its profits to support basic local telephone service. To the extent that elimination of the Dex contribution delays or impedes the ultimate elimination of other support mechanisms, the interests of competitors and competition overall are clearly being disserved, not advanced.

Second, if in fact the yellow pages imputation is actually distorting and impairing competition as QC and Dex both suggest, then the settlement simply perpetuates this distortion for fifteen years. In view of the fact that the settling parties have crafted a plan that provides *them* with immediate benefits, their suggestion that competitors and competition will also be benefitted beginning in year 16 can most charitably be characterized as disingenuous.

The risks and uncertainties associated with the sale of Dex require that, if the sale of Dex is ultimately approved, ratepayers receive more of their share through an up-front payment rather than through potentially worthless "revenue credits."

Q. If the settlement as proposed does not satisfy the Commission's guidelines for transactions involving the sale of utility assets, what alternatives should the Commission consider?

A. Staff continues to believe that the proposed sale of QC's Washington directory publishing operations to Dex Holdings, L.L.C. is not in the public interest and should be rejected. Retention of the Washington directory publishing business will help to assure and to maintain QC's financial health and strength far better than the distress sale of this quality and valuable asset.

Q. Could QC efficiently operate a directory publishing activity that is limited to Washington on a stand-alone basis?

A. Perhaps, but there would be no necessity for that to be the outcome. QC-Washington can enter into a directory publishing agreement with a multistate directory publisher under which it would convey the "official publisher"designation and the various rights attendant thereto in exchange for an ongoing license fee that would likely exceed the minimal "revenue credit" that is being proposed under the settlement.

Q. With whom might such an arrangement be established?

A. In its FAS 141 Report (Exhibit 243), Murray Devine suggested that another RBOC might be interested in taking on the QC directory business in the event that QC decided to breach the Non-Competition Agreement with Dex and reenter the yellow pages business. I would expect that another RBOC would be even more interested in becoming QC Washington's "official" directory publisher if the Washington directory operations are not taken over by Dex to begin with. Verizon's directory affiliate, Verizon Information Services, is certainly a logical candidate. Verizon currently serves roughly 25% of local service customers in Washington, and already publishes yellow pages directories serving portions of the Seattle metro and other Qwest-served areas. Alternatively, QC Washington could enter into a publishing agreement with Dex itself, licensing the "official" status in exchange for an ongoing licensing fee that would continue for as long as the publishing agreement remained in place. By contrast, under the terms of the proposed settlement, Dex obtains a Non-Competition Agreement with QC that remains in effect for forty years, a Publishing Agreement and status as "official" publisher than remains in effect for fifty years, yet pays no licensing fee (other than the nominal charge for directory listings) to QC at all. And even the "annual revenue credit" would last for only fifteen years.

Q. In the event that the Commission determines that the sale of Dex should be approved with conditions, are there modifications to the proposed settlement that could be made that would bring the proposed transaction into closer conformity with the *Colstrip* guidelines?

A. The terms of the settlement are sufficiently far from satisfying the "no ratepayer harm" standard that it is difficult to imagine how it could be adjusted to eliminate this serious deficiency. However, Dr. Blackmon has already provided the Commission with recommended conditions, in the event that the Commission determines that the sale should be pursued.

Q. Does this conclude your supplemented direct testimony at this time?

A. Yes, it does.