1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25

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 **BRIEF OF AARP, PUBLIC COUNSEL AND WeBTEC**

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25

TABLE OF CONTENTS

I. INTRODUCTION 1

A. Overview of the Dex Transaction. 1

i. Background. 1

ii. Dex Would Not Now Be Sold but for Severe Liquidity Pressure on Qwest and the Attendant Risk of Bankruptcy. The Proposed Sale Will Provide Near Term Improvements in Qwest's Financial Conditions. 4

B. The Commission Has Jurisdiction Over the Transaction. 5

C. As Conditioned by the Stipulation the Dex Sale Is in the Public Interest and Should Be Approved. 7

II. ARGUMENT 8

A. Sale of Dex is Appropriate and Necessary to Allow QCII to Improve Its Liquidity and Access to Capital Markets on Reasonable Terms. 8

i. All Parties Except Staff (and XO) Have Concluded that the Sale of Dex is An Appropriate Measure to Improve Liquidity and Repay QCII/QC Debts. 8

ii. Evidence of Cummings/Johnson Regarding Liquidity Issues is Compelling. 9

iii. The Commission Should Not Risk the Potential Bankruptcy of QCII with Uncertain Impacts Upon the QC Business, Particularly When the Stipulation Provides Sufficient Safeguards to Protect Ratepayer Interests In the Directory Business. 10

iv. Staff's Proposed Rejection of the Dex Sale Provides Little Certainty that the Public Interest Will Be Protected. 12

(a) Staff Offers No Independent Projections of Cash Flows or Reliable Analysis of Outcomes from Bankruptcy Scenarios In Support of Its Primary Recommendations. 13

(b) Renegotiation of Rodney Without Washington Assets Would Likely Create a Crippled Shell of Directory Business, Reduced Value for Future Imputations and Higher Resulting Revenue Requirements, Thereby Harming Ratepayers. 14

(c) Any Ability for QCII to Reasonably Renegotiate Rodney Excluding WA-DEX Operations Is Highly Uncertain. 17

(d) There Is No Alternative Transaction Structure Consistent With Staff's Recommendations. 18

(e) The Value of Potential Future Imputation to Customers is Uncertain Under a Business as Usual Analysis and is Very Questionable if All of Dex Except Washington is Sold to Dex Holdings. 19

B. As Conditioned By the Stipulation the Dex Sale Is in the Public Interest. 20

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

i. The Stipulation Reflects a Reasonable Compromise of the Positions of the Settling Parties. 20
(a) Qwest's Application and Direct Testimony Provided for Minimal Consumer Protections and a Limited Benefit to Ratepayers from the Sale. 20
(b) AARP, Public Counsel and WeBTEC's Direct Testimony Provided for a Greater Degree of Protection for Consumers and 100 Percent Benefit to Ratepayers of the Washington Allocation of the Gain on Sale. 21
(c) DOD's Direct Testimony Placed an Even Greater Value on the Washington Share of the Gain on Sale. 25
(d) The Stipulation Strikes a Reasonable Balance Between these Positions. 25
ii. The Stipulation Will Protect the Public Interest. 27
(b) The Stipulation Captures an Appropriate Share of the Gain on Sale for Ratepayers. 28
(c) The Rodney Transactional Agreements Provide Reasonable Assurances Regarding Continued Directory Publications in Washington. 28
(d) The Stipulation Responds to the Concerns of AARP, Public Counsel and WeBTEC and to All Material Public Interest Issues Raised by the Proposed Sale of Dex. 29
(i) Up-Front Bill Credits Provide An Assured Benefit to All Current Qwest Customers Regardless of Whether They Receive Tariffed, Price-Listed or Contracted Service. 29
(ii) The Stipulation Preserves a Reasonable Level of Contribution from Directory Publishing for Washington Revenue Requirement Protection. 32
(iii) The Customer Protection Measures Provide Additional Near Term Assurances Regarding Customer Services. 38
C. Adoption of Staff's Positions Regarding Alternative Economic Relief to Customers Creates Unnecessary Risks and No Certainty of Benefits for Customers. 39
i. Staff's Recommended Financial/Capital Structure Constraints and Washington Publishing Contract Requirement, that Are Intended to 39
i. Protect QC From Its Parent/Affiliates, Are Unproven and Not Fully Developed or Supported by the Record. 40
ii. A Reasonable Balancing of Interests of Consumers and Shareholders is Provided for in the Stipulation that Does Not Expose Ratepayers to the Risks Created by Staff's Proposals. 41
iii. Dr. Selwyn's Rate Base Off-Set Suggestion Creates More Problems Than It Solves. 42

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

III. CONCLUSION 45

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25

I. INTRODUCTION

1. AARP, the Public Counsel Section of the Washington State Attorney General's Office ("Public Counsel"), and the Washington Electronic Business & Telecommunications Coalition ("WeBTEC") respectfully request that the Washington Utilities and Transportation Commission ("Commission") approve the proposed sale of the Qwest Dex, Inc. ("Dex") business to Dex Holdings, LLC ("Dex Holdings") as conditioned by the Stipulation and Settlement Agreement (Stipulation). *Stipulation, Ex. 2*. The Stipulation reached by all parties, except the Utilities and Transportation Section of the Washington State Attorney General's Office ("Staff") (and XO Washington, Inc. ("XO"), reflects a reasonable resolution of the many complex issues presented in the matter now before the Commission. The Stipulation comports with the public interest by serving to protect Qwest's Washington ratepayers' financial interests in Dex as well as ratepayers' operational interests in a financially viable telephone utility that is capable of providing high-quality service.

A. Overview of the Dex Transaction.

i. Background.

2. In order to properly evaluate the proposed Stipulation, it is important to consider the path that led the Commission to where it is today. At the divestiture of AT&T the then Pacific Northwest Bell, precursor to US West, Inc./Qwest, transferred its directory publishing business to an unregulated affiliate, Landmark Publishing Company. Landmark was the precursor to US West Direct, which ultimately became Qwest Dex, Inc. *Burnett Direct, Ex. 51 at 3; Reynolds/Jensen Direct, Ex.61 at 14-15.* Qwest's Washington ratepayer's interest in this asset has been disputed by Qwest and its predecessors virtually since divestiture. It has been the

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

subject of repeated and protracted litigation before the Commission and the Washington state courts with regularity ever since the initial asset transfers were conditionally approved by the Commission in Docket No. FR-83-159.[1] It would be fair to characterize the issues surrounding Dex as one of the longest running and most contentious in the history of telecommunications in Washington. The Dex sale, as conditioned by the Stipulation, would resolve this matter once and for all, as explained by AARP, Public Counsel and WeBTEC's witness Michael Brosch with reference to the most recent Dex-related litigation in Washington:

> I agree that the pending sale of Dex is a true sale of the directory publishing business enterprise that has previously been treated as an outsourced affiliate publishing function by the Commission. Because the affiliate publishing arrangement is to be discontinued and the directory publishing income stream is being sold to yield lump sum proceeds, I also agree that disposition of the gain on sale is now required to account for the liquidation of this regulatory asset. At page 46 of the Order in Docket No. UT-980948, the Commission provided for changes to directory imputation that may be required in stating:
>
> > *179* The Commission will continue to use imputation to preserve and balance the positions of stockholders and ratepayers until the Company demonstrates a change in conditions that warrants a change in imputation.
> >
> > *180* The Commission will then have the opportunity to determine whether to end imputation and, if so, determine the appropriate disposition of any gain.
>
> The sale of Dex fits squarely within these findings and provides the envisioned opportunity to replace imputation with a final disposition of value to customers for the lucrative official publishing rights controlled by Qwest.

Stipulation, Ex. 2; Brosch Direct, Ex. 291C at 25-26.

3. The history of the Dex directory business in Washington is detailed in Qwest

---

[1] WUTC Docket Nos. U-89-2698-F, U-89-3245-P, UT-950200, UT-970766, UT-980948 and *US West v. Utils. & Transp. Comm'n*, 134 Wn.2d 74, 949 P.2d 1337 (1997).

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

witness Theresa Jensen's testimony (as adopted by Qwest witness Mark Reynolds), Qwest witness Philip Grate's testimony and exhibits thereto, as well as being generally discussed in *Qwest Corporation's Application Regarding Transfer and Sale of Directory Business and Notice of Possible Affiliated Interest Transaction* (Application). *Reynolds/Jensen Direct, Ex. 61 at 13-19; Grate Direct, Ex. 101 at 10-22; Ex. 103; Application at 5-7.*

4. As discussed in Qwest's Application and by many of the witnesses in this proceeding, Qwest (collectively, Qwest Communications International, Inc. (QCII),[2] Qwest Services Corporation (QSC), Qwest Dex, Inc. (Dex), and Qwest Corporation (QC)) has proposed to sell the Dex directory business to Dex Holdings for $7.05 billion. *Application at 3-5; Dexter & Rodney Agreements, Ex. 1; Cummings/Johnson Direct, Ex. 171 at 8-10.* The transaction has been structured into two parts dividing the entire Dex operations between two groups of states, one referred to collectively as the "Dexter" transaction and the other referred to as the "Rodney" transaction. Washington is part of the Rodney transaction. The transactional agreements and all the ancillary agreements are reflected in *Exhibit 1* and discussed by Mr. Burnett in his direct testimony in *Exhibit 51 at 8-12*. The Dexter portion of the transaction has already closed, and required regulatory approvals for the Rodney transaction remain outstanding in only Arizona and Washington. *Brosch Direct, Ex. 291C at 25, 73.*

5. The Stipulation entered into by AARP, Public Counsel, WeBTEC, the Department of Defense and all other Federal Executive Agencies (DOD), Qwest and Dex Holdings (collectively "the Settling Parties") provides a reasonable resolution of this long standing and contentious dispute. *Stipulation, Ex. 2; Brosch Supplemental, Ex. 306*. The

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

Stipulation is more fully described below in Section II.B.

ii. Dex Would Not Now Be Sold but for Severe Liquidity Pressure on Qwest and the Attendant Risk of Bankruptcy. The Proposed Sale Will Provide Near Term Improvements in Qwest's Financial Conditions.

6. There has been virtual unanimity amongst all parties reviewing this transaction, except Staff, that, but for the proposed sale of Dex, it is highly probable that Qwest would have been forced to either declare bankruptcy or have its creditors file against it in the U.S. bankruptcy courts. *Cummings, Tr. 562, l. 11-15; King, Tr. 598, l. 2-4; Reynolds, Tr. 1049-1052*. While this transaction cannot be said to eliminate all future risk of a bankruptcy filing, it does provide a reasonable degree of assurance that Qwest will be able to meet its financial obligations through at least 2005. *Cummings, Tr. 560, l. 12-18.* There are real and measurable advantages to ratepayers of QC from the Stipulation, in addition to avoiding the risks attendant to a QCII bankruptcy. *King, Tr. 613, l. 11-22*. Qwest must improve its financial condition if it is to continue to improve its service to ratepayers. The uncertainties that would accompany a bankruptcy filing would not be in the public interest given the reasonable protections available through the Stipulation now before the Commission.

7. It is clear from witness testimony in this proceeding that Qwest would not be selling Dex were it not in the financially precarious position it now occupies. *Cummings/Johnson Direct, Ex. 171 at 4-8; Cummings Direct, Ex. 172 at 8-21; Brosch Direct, Ex. 291C at 43-44; Kennard, Tr. 338, l. 17-21; Brosch, Tr. 1285-1286.* Beginning in 2002, Qwest began to have extreme difficulty servicing its existing debt. When Qwest was forced to exercise a $4 billion credit line on February 14, 2002, it became clear that bankruptcy was

[2] QCI and QCII were used interchangeably during the hearings.

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

imminent absent a significant change in the *status quo*. Qwest's former management began the process of considering which assets could be profitably sold in order to improve its balance sheet and enable Qwest to service its debt in the near term. Dex quickly became a focus of their consideration.

8. As discussed by Qwest witness Ralph Mabey, a bankruptcy filing by Qwest would create a range of uncertainties that could impair this Commission's ability to protect the public interest. *Mabey, Tr. 715, l. 10-19.* Any potential loss of Commission jurisdiction over matters beyond traditional rate setting could create the serious possibility of risks of harm to Qwest's Washington ratepayers that the Commission may be unable to ameliorate. *Mabey, Tr. 718-720; Mabay Tr. 751, l. 4-12.* As Dex Holdings' witness William Kennard said regarding the bankruptcy of telecommunication companies he experienced as chairman of the FCC, "…it is pretty devastating from a regulatory standpoint, because you lose control, and the jurisdiction is transferred to the bankruptcy court." *Kennard, Tr. 353, l. 7-11.* It is clear that regulating a telecommunications company in Chapter 11 causes regulatory difficulties and uncertainties, as well as a risk of harm to ratepayers, such as service quality problems. *Id.* These risks can be avoided if the Stipulation is approved. As Mr. Kennard stated upon questioning from the Chairwoman, "…I think it becomes very remote that Qwest goes into bankruptcy if this deal is approved, because I think that they're basically out of the woods." *Kennard, Tr. 355, l. 5-7.* The evidence supporting this position is more fully discussed below in Section II.A.i.

B. <u>The Commission Has Jurisdiction Over the Transaction.</u>

9. The Commission has jurisdiction over the proposed transaction under the first

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

clause of RCW 80.12.020. The applicable part of that statute reads as follows:

> No public service company shall sell, lease, assign or otherwise dispose of the whole or any part of its franchises, properties or facilities whatsoever, which are necessary or useful in the performance of its duties to the public … without having secured from the commission an order authorizing it so to do …

RCW 80.12.020.

10. There is no dispute that Qwest Corporation is currently, and will continue to be, a public service company for purposes of RCW 80.12.020, and as such it may not dispose of any part of its property "necessary or useful in the performance of its duties to the public" without the Commission's approval. The scope of the statute is broad in its application to transactions. The phrase "otherwise dispose of" gives the Commission the ability to review not just sales, leases, and assignments, but to review any type of disposition, however structured, which results in the transfer of "any part…whatever" of company facilities or property. This language is more than broad enough to encompass this transaction.

11. The Commission's authority to regulate certain transactions of public service companies is inextricably linked to the legislative policy articulated in RCW 80.01.040 establishing the general powers and duties of the Commission:

> The utilities and transportation commission shall: … (3) Regulate in the public interest, as provided by the public service laws, the rates, services, facilities, and practices of all persons engaging within this state in the business of supplying any utility service or commodity to the public for compensation, and related activities; including, but not limited to, … telecommunications companies…

RCW 80.12.020.

12. By delegating to the Commission the express authority to "regulate in the public interest" the legislature has given the Commission an important interpretive tool. Any

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

interpretation of the statutes in RCW title 80 must take into account the legislature's express requirement that the Commission consider the actions of public service companies in light of their duties to the public. The language of RCW 80.12.020 itself provides a link to and a reminder of the "public interest" component of the Commission's powers by tying the review authority to transfers of facilities and properties which are "necessary or useful in the performance of [the company's] duties to the public."[3]

13. The legislative policy articulated in RCW 80.01.040, and echoed in RCW 80.12.020, supports a broad interpretation in keeping with the Commission's broad powers to regulate in the public interest. *See generally, U.S. West Commun. v. Washington Util. & Transp. Comm'n*, 134 Wn.2d 74, 96, 949 P.2d 1337, 1348 (1998)("The Commission has broad authority to regulate the practices of public utilities."); *Tanner Electric Corp. v. Puget Sound Power & Light*, 128 Wn.2d 656, 682, 911 P.2d 1301, 1314 (1996)("The public utilities industry is one where the legislature has decided that the public interest is best served by direct and uniform regulation of almost every phase of industry activity."). AARP, Public Counsel and WeBTEC believe the Commission should continue to maintain today, as it has in the past, that it has jurisdiction over this asset and transaction. It is worth noting that approval of the Stipulation would avoid any appeal on jurisdictional grounds.

C. As Conditioned by the Stipulation the Dex Sale Is in the Public Interest and Should Be Approved.

14. AARP, Public Counsel and WeBTEC respectfully request that the Commission

[3] WAC 480-143-050 provides that transfer applications which are not consistent with the public interest shall be denied by the Commission.

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

approve the Dex transaction as conditioned by the Stipulation. It is our position that the Stipulation represents a reasonable resolution of the issues presented to the Commission in this docket and adequately compensates Qwest's ratepayers for their interest in the Dex asset. The Commission should reject the proposals and various suggestions of Staff and its witness Dr. Lee Selwyn which are inconsistent with the Stipulation, and the preponderance of evidence, now before the Commission. As a reasonable compromise of the positions of the Settling Parties, AARP, Public Counsel and WeBTEC request that the Commission enter an order approving the Stipulation, the Dex sale and the related commercial agreements.

II. ARGUMENT

A. Sale of Dex is Appropriate and Necessary to Allow QCII to Improve Its Liquidity and Access to Capital Markets on Reasonable Terms.

15. AARP, Public Counsel and WeBTEC believe that the Dex transaction, as conditioned by the Stipulation, is a reasonable and appropriate means to protect Qwest's Washington ratepayers while allowing Qwest to de-lever its balance sheet, improve its near term financial condition, and avoid bankruptcy. It is clear that Qwest must improve its financial condition if it is to continue to improve its service to customers. The possibility of bankruptcy carries uncertainties and risks that would not be in the public interest, given the reasonable assurances provided by the Stipulation now before the Commission. Unfortunately, the recommendations of Staff provide no such certainty and risk significant harm to Qwest's Washington ratepayers.

i. All Parties Except Staff (and XO) Have Concluded that the Sale of Dex is An Appropriate Measure to Improve Liquidity and Repay QCII/QC Debts.

16. All parties save Staff concur that the sale of Dex is a reasonable response to the

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

severe financial constraints Qwest began to face in 2002. *Cummings Direct, Ex. 172; Kennard Direct, Ex. 241; King Direct, Ex. 271; Brosch Direct, Ex. 291C.* As explained by Mr. Brosch in his direct testimony, "[u]nfortunately, QCI will sorely miss the income and cash flow produced by Dex after the sale, but the Company had little choice but to monetize this asset to meet the demands of its creditors." *Brosch Direct, Ex. 291C at 16-17; Id. at 43-45.*[4] AARP, Public Counsel and WeBTEC believe the Commission should approve the sale of the Dex asset to Dex Holdings as conditioned by the Stipulation.

ii. Evidence of Cummings/Johnson Regarding Liquidity Issues is Compelling.

17. The testimony and evidence presented by Qwest witness Peter Cummings (including the adopted testimony of Qwest witness Brian Johnson) is compelling evidence regarding the liquidity crisis Qwest began to face in 2002. *Cummings/Johnson Direct, Ex. 171 at 4-13; Cummings Direct, Ex. 172 at 8-21; Brosch Direct, Ex. 291C at 44.* By February 2002, QCII and QC were unable to access the commercial paper market, forcing them to exercise a $4 billion syndicated bank credit facility in order to cover then existing commercial paper debt. *Cummings Direct, Ex. 172 at 10.* In essence, to avoid defaulting on billions of dollars of short term debt on February 14, 2002 Qwest was forced to exercise the corporate equivalent of a personal line of credit to forestall bankruptcy.

18. Subsequently, QCII and QC's bond ratings were downgraded by the credit agencies and then downgraded again to "junk" bond rating levels. *Id. at 15; Ex. 175.* Additionally, in early 2002 the Securities and Exchange Commission began informal and then formal investigations of Qwest's accounting policies. *Cummings Direct, Ex. 172 at 12.* While

[4] Qwest CEO Notebaert said as much while visiting the Commission in the Fall of 2002 shortly after his hiring.

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

Qwest proceeded to renegotiate and seek amendment to various credit facilities it was clear that the renegotiations in and of themselves were inadequate to provide Qwest sufficient liquidity on a going forward basis without the Dex transaction. *Cummings Direct, Ex. 172 at 12-21*. Mr. Cummings stated that the sale of Dex (both Dexter and Rodney) remains critical to Qwest's ability to avoid bankruptcy in the short and intermediate terms. *Id. at 21; Cummings, Tr. 557-558.* Without announcement of the Dex sale, Qwest would have been unable to renegotiate the second amended and restated credit agreement (ARCA). *Cummings, Tr. 665, l. 17-24.* After considerable discovery and evaluation, AARP, Public Counsel, WeBTEC and DOD recognized this reality early in the proceedings and it informed their analysis and advocacy throughout this case. *King Direct, Ex. 271 at 6-7; Brosch Direct, Ex. 291C at 44.*

iii. The Commission Should Not Risk the Potential Bankruptcy of QCII with Uncertain Impacts Upon the QC Business, Particularly When the Stipulation Provides Sufficient Safeguards to Protect Ratepayer Interests In the Directory Business.

19. The possible failure of the Rodney transaction poses significant bankruptcy risks for QCII and QC. If QCII was to file for protection with the bankruptcy courts, it would likewise create significant uncertainty and risks for QC and its Washington ratepayers. *King, Tr. 590, l. 10-16; Mabey, Tr. 715, l. 10-19; Mabey, Tr. 751, l. 4-12; Reynolds, Tr. 1026, l. 10-19.* These risks include the possible curtailing of the Commission's jurisdictional authority over transactions QC might be directed to engage in by the bankruptcy court. *Mabey, Tr. 718-719.* It is the position of AARP, Public Counsel and WeBTEC that the Stipulation represents a reasonable baseline of protections to protect QC's Washington ratepayers' interest in the Dex directory business. In a bankruptcy proceeding, which included Dex, such ratepayers' interests

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

may have little protection. *Brosch Direct, Ex. 291C at 45.*

20. As discussed by Mr. Mabey, in the event of a bankruptcy filing by QCII, it may be difficult to protect the Commission's jurisdiction over the sale of Dex as well as QC's Washington ratepayers' interest in the Dex sale. *Mabey Rebuttal, Ex. 211 at 8-13; Mabey, Tr. 718-719.* Neither QCII nor this Commission would have control over the ultimate outcome of a QCII bankruptcy proceeding. While the extent of jurisdictional preemption in the event of a QCII bankruptcy is unknown, it appears a few certainties exist. First, the Commission's jurisdiction would be impaired to some degree. *Id.* Second, QCII's creditors would have a significant influence over the outcome of the bankruptcy proceeding. Third, these creditors' interests may run counter to the interests of QC's Washington ratepayers. Fourth, QC's Washington ratepayers would have little if any influence over the outcome of the bankruptcy proceeding. Fifth, a possible bankruptcy filing by QCII or its creditors would be expensive. *Mabey Rebuttal, Ex. 211 at 18-19.* Recovery of those costs could be sought from ratepayers. The outcome of a QC bankruptcy would be unpredictable. *Mabey, Tr. 715, l. 10-19.* As Mr. Mabey noted, completing this transaction removes one incentive QCII may have to include QC in a bankruptcy. *Mabey, Tr. 729, l. 3-16.*

21. The Stipulation provides for closing the Rodney transaction with realized cash proceeds being available to satisfy creditors. *Brosch Supplemental, Ex. 306 at 6.* There is no need to expose Washington ratepayers to the uncertainties associated with bankruptcy because the Stipulation provides for customer participation in the gain to be realized upon closing for the transaction through significant one-time customer bill credits, while also securing future rate stability through 15 years of future ratemaking revenue credits, while, at the same time,

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

1 eliminating near-term bankruptcy risks. *Id. at 5.*

2 **iv. Staff's Proposed Rejection of the Dex Sale Provides Little Certainty that**
3 **the Public Interest Will Be Protected.**

4 *22.* Staff's primary recommendation is that the Commission should reject the
5 proposed Dex sale. *Selwyn Direct, Ex. 311 at 109; Selwyn Supplemental, Ex. 363TC at 12;*
6 *Blackmon Direct, Ex. 370 at 3; Blackmon, Tr. 1379, l. 16.* Even under a hypothetically
7 imminent bankruptcy filing, Dr. Selwyn would still recommend that the Commission deny the
8 transaction. *Selwyn, Tr. 823-824.* Unfortunately, Staff and their expert fail to provide adequate
9 assurances or predictability that Qwest's Washington ratepayers' interest in the Dex directory
10 business will be protected if the Commission were to adopt their primary recommendation.
11 *Reynolds Supplemental, Ex. 94.* Further, Dr. Selwyn's valuation analysis assumes matters not
12 in evidence in this proceeding and which are highly questionable – including a growing, and
13 never ending imputation being chief among them. *Taylor Rebuttal, Ex. 221 at 27; Kalt*
14 *Rebuttal, Ex. 261C at 5-13; Selwyn, Tr. 866, ll. 17-20.* It was AARP's, Public Counsel's and
15 WeBTEC's concern for protecting Qwest's Washington ratepayers' interests and the public
16 interest generally that led to Mr. Brosch's use of actual sale proceeds as the foundation of his
17 analysis. It was this realistic approach to determining the Washington ratepayer's interest in the
18 transaction that made possible the Stipulation now before the Commission. *Brosch Direct,*
19 *Ex. 291C at 53-54.* Rather than speculate regarding the appropriate valuation for the Dex
20 business, or whether Qwest's imminent need to improve liquidity and repay debt is real, we
21 urge the Commission to accept the agreed-upon regulatory remedies as conditions to its
22 approval of the sale of Dex.
23
24
25

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

(a) Staff Offers No Independent Projections of Cash Flows or Reliable Analysis of Outcomes from Bankruptcy Scenarios In Support of Its Primary Recommendations.

23. Staff's primary recommendation is that the Commission should reject the transaction. *Selwyn Direct, Ex. 311 at 109; Selwyn Supplemental, Ex. 363TC at 12; Blackmon Direct, Ex. 370 at 3; Blackmon, Tr. 1379, l. 6.* Staff believes that, even without the Rodney sale, QCII will not file for bankruptcy within the foreseeable future. *Blackmon, Tr. 1462, l. 2-7.* Unfortunately, Staff provides the Commission with no financial analysis supporting its position that QCII has no risk of bankruptcy for the foreseeable future. Nor has Staff provided the Commission with a financial or cash flow analysis rebutting the analysis and testimony of Mr. Cummings on this topic.

24. Staff has offered unsupported theories regarding how the Rodney transaction might proceed without Washington directory operations. Specifically, Staff would have the Commission requiring Qwest to form a Washington-specific Dex directory business, or "WA-DEX." *Blackmon, Tr. 1470.* Unfortunately, Staff has failed to support this recommendation with any analysis that supports the proposition that the WA-DEX would be a financially viable entity. The lack of such a supporting analysis severely undermines the credibility of this recommendation by Staff and its witness Dr. Selwyn. Dr. Selwyn, himself, admitted that it is impossible to predict with any certainty the long term value of a WA-DEX business. *Selwyn, Tr. 967, ll. 19-23.* Essential to Staff's theory regarding WA-DEX is that the stand-alone business would achieve future financial results sufficient to perpetuate imputation at historical levels. Otherwise, WA-DEX would be a losing proposition in relation to the Stipulation that provides certainty regarding customer bill credits and ongoing revenue credits. The record

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

reflects no projections of future directory publishing profits or regulatory imputation that might result from Staff's proposed separation of Washington directory operations from the Rodney transaction.

(b) Renegotiation of Rodney Without Washington Assets Would Likely Create a Crippled Shell of Directory Business, Reduced Value for Future Imputations and Higher Resulting Revenue Requirements, Thereby Harming Ratepayers.

25. Assuming for purposes of argument that the Commission conditions approval of the Rodney portion of the Dex sale upon the formation of a WA-DEX entity to be retained by Qwest, it is highly questionable whether this would result in an outcome favorable to Qwest's Washington ratepayers. *Brosch Direct, Ex. 261C at 16-17.* When asked about the viability of Qwest trying to create its own directory business immediately after closing Rodney, Mr. Kennard commented, "Yes, it's a fantasy, it wouldn't happen." *Kennard, Tr. 324, l. 13.* There is no provision for this outcome in the current transaction and it would have to be renegotiated. *Dexter & Rodney Agreements, Ex. 1; Kennard, Tr. 339, ll. 2-13.* It is uncertain whether this is at all possible. The liquidated damages clause triggered by Qwest's reentry into the directory business could cost it as much as $2.1 billion. *Kennard, Tr. 277-281.* Additionally, Qwest would be required to devote considerable capital to redeveloping the business it had just sold, capital it does not possess. *Kennard, Tr. 324, ll. 16-19.* The resulting WA-DEX company would lack the strategic assets and supporting employee base to be as strong a competitor in the directory business. Moreover, it is almost certain that Dex Holdings (non-WA-DEX) would enter the Washington yellow pages market. *Kennard Rebuttal, Ex. 242C at 10.* As described by Mr. Kennard, the employee base and its on-going relationships

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25

with the advertiser base is "one of the principal values that we thought we were buying…" This is critically important for yellow pages advertising since the average revenue per user is roughly $3000. Thus, unlike many other businesses, a small percentage of the customers do not account for the majority of the revenue. *Kennard, Tr. 304-305.* In discussing this very scenario, Mr. Kennard stated "[b]ut again, absent those employees and those customer relationships, it would be very difficult [for Qwest] to launch a competing business." *Kennard, Tr. 306, ll. 22-25.* In response to a question upon redirect on what would happen if the buyer and seller were unwilling or unable to renegotiate Rodney without Washington, Mr. Reynolds stated, "I think we're back to the point that I discussed, and it would be that the Rodney sale would not go through, and it has the impact of us not receiving $4.3 billion that I believe we need to stay out of bankruptcy." *Reynolds, Tr. 1202, l. 23-1203, l. 2.*

26. As alluded to above, WA-DEX would lack the strategic assets which would be lost in the hypothetical Dex Holdings non-WA-DEX Rodney sale. As discussed by Mr. Kennard, Staff's WA-DEX would lack the computer systems, national customer data and relationships, senior management expertise, the Dex brand name and trademarks, and related assets. *Kennard Rebuttal, Ex. 242C at 10.* Mr. Kennard explained:

> Well, it would be a pretty unattractive business, because they would - they would be denied all of the corporate support that they need to run the business, IT services, legal, accounting, finance, you know, all of the functions that they would need to be a functioning business would have to be replicated at, you know, great cost, and I think it would make them vulnerable as a stand alone business… Washington as a stand alone company with no infrastructure would be a sitting duck for competitors, because they would be a weakened company without the infrastructure, and it would not be a very attractive business to own.

Kennard, Tr. 351, l. 5-352, l. 1.

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

27. Mr. Reynolds also testified, "…you're going to have Dex entering from its 13 state operations, trying to retain the market share it had before." *Reynolds, Tr. 1149-1154*. Clearly, in the event the Commission orders a stand-alone one-state WA-DEX be created, that directory business will face significant competitive challenges.

28. Further, the benefit Qwest's Washington ratepayers derive from a WA-DEX would be impaired under Staff's proposal as Qwest would have to develop the resources otherwise lost through the non-WA-DEX sale, including possibly re-establishing the sales force. Qwest witness George Burnett testified about the extensive efforts that would be necessary to reconstitute a WA-DEX operation. *Burnett, Tr. 444-449*. The capital costs, the transactional hurdles and the presence of the non-WA-DEX as a competitor all bring into question the viability of Staff's proposed Washington specific "WA-DEX" directory operation. Additionally, as testified by Mr. Burnett, Staff's WA-DEX proposal would suffer from lost economies of scale in operating WA directory. *Id., Tr 421-422*. This would also significantly contribute towards higher operating costs, thus lower imputation values, and higher rates for Qwest's Washington ratepayers. *Kennard, Tr. 352, ll. 6-8.*

29. Under Staff's WA-DEX proposal, the Commission would be forced to again engage in a transactional review process after the hypothetical renegotiation of the Rodney transaction. Staff's WA-DEX proposal appears to grandly assume that certain key Washington-specific assets and employees would remain with the WA-DEX business. In such a scenario, the Commission would have to again review a new renegotiated Rodney transaction to assure itself that its order was complied with by Qwest and Dex Holdings. In such a renegotiation, there would be significant business incentives to read the Commission's order perhaps more

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

narrowly than intended and result in lost business opportunities which the Commission had intended to remain with WA directory. This of course presumes that the result of a WA-DEX order from the Commission is not a bankruptcy filing which would almost certainly divest the Commission of the authority over subsequent transactions, including the Washington directory business, leaving the Commission with jurisdiction only over the regulatory treatment in rates of the transaction. In short, Staff's WA-DEX proposal is unproven and prone to collapse under the weight of its many complexities.

(c) Any Ability for QCII to Reasonably Renegotiate Rodney Excluding WA-DEX Operations Is Highly Uncertain.

30. It is unclear whether Qwest and Dex Holdings would be able to renegotiate a non-WA-DEX sale of Rodney under the conditions requested by Staff. *Kalt, Tr. 757-758; Reynolds, Tr. 1076, ll. 5-10.* Mr. Reynolds testified that he believes Qwest would attempt to renegotiate Rodney in the face of the Commission's adoption of Staff's recommended conditions. *Reynolds, Tr. 1124, ll. 10-19.* However, it may be that the loss of the Washington market, or Staff conditions for inclusion of it, would sufficiently degrade the value of the transaction to Dex Holdings such that the aggregate value of (a) non-WA-DEX; or (b) all of Rodney with Staff conditions either costs more than Dex Holdings is willing to pay, or results in an offer less than the amount Qwest is willing to accept for the sale. It is also questionable whether Dex Holdings would be able to finance a significantly modified transaction in the current capital markets. *Kennard, Tr. 315*

31. The Publishing Agreement and the numerous other commercial agreements reflected in *Exhibit 1* form a comprehensive set of terms and conditions which will govern the

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

relationship between Qwest and Dex Holdings once the sale is completed. The benefits of the publisher/telephone company relationship were formerly assured through the common corporate ownership and control of QC and Dex by QCII. *Brosch Direct, Ex. 291C at 35-39. Exhibits B, C, D, G, H, I, J, K, L, M and Q* are incorporated into the Rodney agreement and would require careful renegotiation to carve-out the Washington portion of the publishing region referenced therein. Much of the value being sold to the buyer of Dex is associated with these agreements, making the reformulated value of Rodney without Washington difficult to quantify and highly dependent upon revised terms and conditions. It is a matter of significant uncertainty whether Qwest and Dex Holdings would be able to reconstitute a non-Washington Rodney agreement and also reasonably renegotiate all of the commercial agreements or terms that did not disadvantage the stand-alone WA-DEX publishing business envisioned by Staff.

(d) There Is No Alternative Transaction Structure Consistent With Staff's Recommendations.

32. It does not appear to AARP, Public Counsel and WeBTEC that there is an alternative structure to the proposed transaction which would be consistent with Staff's recommendations. To put it differently, Staff has a number of alternative, broadly-defined proposals for which no practical means of implementation appear to exist. Tremendous uncertainty exists as to whether and how Qwest would be able to separate a Washington-specific directory business from the rest of the Rodney transaction. As noted above, the full range of commercial agreements representing the Rodney transaction would have to be renegotiated. *Rodney Agreements, Ex. 1.*

33. Setting aside the questions relating to the scope of the Commission's jurisdiction

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

to order such an arrangement, it is clear that the Rodney renegotiation would require considerable time and expense to create. Assuming there could be a successful second round of Rodney and commercial agreements renegotiation to carve out a WA-DEX operation, the separation of intangible assets would still be complicated. *Selwyn, Tr. 992; Selwyn Tr. 1002-1003*. The allocation of shared automated-support systems, customer relationships, resources and employee groups would be extremely contentious and it would be necessary for QCII and QC to assure themselves that, in renegotiating the transaction, they retain the value for which they were not being compensated. *Selwyn Tr. 1002*. The Commission should consider how separating a WA-DEX business would likely destroy economies of integrated directory operations, expose that business to direct competition from the buyer of Dex, and thereby dilute the eventual benefit sought through the creation of a stand-alone WA-DEX directory.

(e) The Value of Potential Future Imputation to Customers is Uncertain Under a Business as Usual Analysis and is Very Questionable if All of Dex Except Washington is Sold to Dex Holdings.

34. The historical value of the Dex business has been conveyed to Qwest's Washington ratepayers via imputation to Qwest's revenue requirement, thereby decreasing the revenue requirement and resultant basic rates. It is highly speculative of Staff to assume that imputation values would remain constant, or grow after the Dex business is sold in all states except Washington. The evidence now before the Commission indicates that a Qwest WA-DEX business may well return a decreased benefit to Washington ratepayers as a result of lost economies and increased costs associated with a stand-alone Washington directory operation. There is also a risk of near-term net losses while the WA-DEX re-establishes those functions

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25

and acquires the strategic assets lost through the remaining non-WA-DEX sale. The increasingly competitive directory business also could cause a decrease in the imputation figure regardless of this transaction since the incumbent yellow pages have recently shown declining revenues, usage, and number of advertisers. *Kennard, Tr. 336-337; Burnett, Tr. 430-431.* Further, as discussed above, it is also highly speculative whether a non-WA-DEX sale would proceed at all, or on terms that are not extremely adverse to Qwest's financial condition.

B. As Conditioned By the Stipulation the Dex Sale Is in the Public Interest.

i. The Stipulation Reflects a Reasonable Compromise of the Positions of the Settling Parties.

(a) Qwest's Application and Direct Testimony Provided for Minimal Consumer Protections and a Limited Benefit to Ratepayers from the Sale.

35. Qwest's application and direct testimony provided for minimal consumer protections and a limited benefit to ratepayers from the sale of the Dex business. Qwest proposed that the Commission should address the financial disposition of the sale by issuing an order that continues existing directory earnings imputation until any ratepayer interest in the sale proceeds is satisfied. *Reynolds Direct, Ex. 61 at 6, ll. 1-4; 24, ll. 13-14*. Qwest asserted that Washington ratepayers are entitled to no more than 50 percent of the gain realized from the sale of tangible assets under the guidelines established in the *Democratic Central Committee* case but said that it was "willing to share 50% of the after-tax gain associated with primary Qwest listings as the appropriate share to be allocated to ratepayers for continued imputation at the current level." *Id. at 33, ll. 15-20*. Specifically, Qwest proposed that Washington ratepayers receive "the current value of the existing imputation" of $103.4 million as an adjustment to revenues until 2008 (about four and one-half years). *Id. at 19, ll. 19-21; 20, ll. 12-14; Ex. 62C*.

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25

36. According to Mr. Brosch's calculations, the effect of Qwest's proposal would be to attribute approximately 65 percent of the overall after-tax gain on the sale to QCII shareholders, leaving Washington ratepayers with only 35 percent of the gain on the sale. *Brosch Direct, Ex. 291C at 21.*

37. In its rebuttal testimony, Qwest modified its proposal to respond to opposing party testimony that Qwest's gain disposition proposal is insufficient to satisfy ratepayers' interest in the directory publishing asset and "to provide Washington with a gain disposition proposal that is consistent with the stipulated settlements in the Utah and Arizona Dex sale proceedings…" *Reynolds Rebuttal, Ex. 64C at 4, ll. 6-11.* Qwest's revised proposal would provide to ratepayers the current value of the existing imputation of approximately $103.4 million as an adjustment to revenues for the regulated results of operations for a period of 10 years after the sale is approved. *Id. at 18, ll. 15-17.*

38. Qwest asserts that the effect of its revised proposal would be to return ***BEGIN CONFIDENTIAL XXXXXXXX END CONFIDENTIAL*** of Qwest's calculation of the gain to ratepayers or to return to ratepayers ***BEGIN CONFIDENTIAL XXXXXXXXXXXXXXXXX END CONFIDENTIAL*** of the gains calculated by AARP, Public Counsel, WeBTEC and DOD, respectively. *Id. at 18, ll 19-20.*

(b) AARP, Public Counsel and WeBTEC's Direct Testimony Provided for a Greater Degree of Protection for Consumers and 100 Percent Benefit to Ratepayers of the Washington Allocation of the Gain on Sale.

39. In contrast to Qwest's initial and revised proposals, AARP's, Public Counsel's and WeBTEC's proposal, as reflected in the original, direct testimony of Mr. Brosch, would

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

1 provide a much greater degree of protection for consumers and a return of 100 percent of the
2 Washington allocation of the gain on sale to ratepayers, based on Mr. Brosch's gain calculation.
3 *Brosch Direct, Ex. 291C; Ex. 292C.*
4
5 40. Mr. Brosch agreed with Qwest that the pending sale of Dex is a true sale of the
6 directory publishing business enterprise that has been previously treated as an outsourced
7 affiliate publishing function by the Commission. Because that arrangement is to be
8 discontinued and the associated income stream is being sold to yield lump sum proceeds, he
9 also agreed that disposition of the gain on sale is now required to account for the sale of this
10 regulatory asset. However, Mr. Brosch did not agree with Qwest's proposal to keep 65 percent
11 of the sale gain for QCII shareholders. *Brosch Direct, Ex. 291C at 20-21.* Instead, Mr. Brosch
12 recommended that the Washington portion of the gain on sale that would be realized by Qwest
13 be attributed entirely to QC customers because the business enterprise being sold is a regulatory
14 asset as evidenced by the series of previous Commission orders addressing imputation.
15
16 41. In calculating the Washington share of the gain, Mr. Brosch accepted the
17 $7.05 billion purchase price negotiated between the buyer and QCII as the measure of the full,
18 fair-market value for the Dex business. He also accepted Qwest's proposal to reduce the Dex
19 sale proceeds for income taxes at a 35 percent federal income tax rate, notwithstanding the fact
20 that Qwest likely will not pay those taxes because it has accumulated large net operating loss
21 carry-forward balances for tax purposes. Because the sources of negative taxable income giving
22 rise to the net operating losses, and the resulting tax circumstances are not related to the
23 business operations of either QC or Dex, he attributed Qwest's shelter from income taxes on the
24 gain entirely to QCII shareholders. *Id. at 41-43.* This opportunity to realize additional cash
25

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

1 flow via tax savings and the regulatory calculations that attribute full income tax rates to the
2 Dex gain even though such income taxes will not be paid clearly advantage QCII shareholders
3 and help solve Qwest's liquidity problems.
4
5 42. In deriving its gain on sale calculation, Qwest also proposed four allocations that
6 carve out portions of the sale price and resulting gain. Specifically, Qwest proposed to carve
7 out a portion of the sale gain attributable to: (1) the sale of the LCI entity; (2) "New Ventures"
8 (the portion of Dex that engages in non-traditional businesses such as internet directories, direct
9 marketing services, and other activities beyond directory publishing); (3) secondary directories;
10 and (4) Dex primary directories – non-Qwest listings. While Mr. Brosch accepted the carve-
11 outs for LCI[5] and New Ventures, he did not accept those for secondary directories and non-
12 Qwest listings. *Id. at 43-50.*
13
14 43. The cumulative difference in the treatment of allocations between Qwest and
15 Mr. Brosch was approximately ***BEGIN CONFIDENTIAL XXXXXX END CONFIDENTIAL***
16 of the sale gain. Mr. Brosch attributed that amount of disputed gain allocation to ratepayers;
17 Qwest attributed it to shareholders. Mr. Brosch also used a slightly higher Washington
18 percentage allocation than Qwest did to reflect as appropriate comparison of Washington
19 directory revenues to total Dex directory revenues, including secondary directories and non-
20 Qwest listings. Qwest excluded revenues attributed to secondary directories and non-Qwest
21 listings from its comparison, and the result is that Qwest's proposed Washington allocation
22 percentage was lower. The allocations and the calculations of the Washington portion of the
23
24
25 [5] LCI is assigned no portion of the gain because "it is highly probably there is no gain on the Dex sale attributable to LCI." *Reynolds Direct, Ex. 61 at 27.*

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

gain on sale are set forth in *Exhibit 292*. In sum, whereas Qwest calculated the Washington share of the gain on sale to be approximately ***BEGIN CONFIDENTIAL XXXXXXXXXXXXX-XXXXXXXXXXXXXXXXXXXXXX)*** ***END CONFIDENTIAL***, Mr. Brosch calculated it to be approximately ***BEGIN CONFIDENTIAL XXXXXXXXXXXXXXXXXXXXXXXXXXXXXX*** ***END CONFIDENTIAL***.

44. Under Mr. Brosch's proposal in direct testimony, the Washington share of the gain would first be used to provide $103.4 million per year of annual revenue credits in lieu of imputation for 20 years. The revenue credits would be applied in all future revenue reporting, earnings investigations, and any revenue requirement calculations considered by the Commission. Second, the remaining share of the gain, ***$147 million***, would be flowed to ratepayers as a one-time customer bill credit on a per-access line basis. To further ensure that continuing QCII liquidity concerns after the sale do not contribute to declines in service quality in Washington, Mr. Brosch proposed that the Customer Service Guarantee Programs in tariff WN U-40, at 2.2.2(B) and the Service Quality Performance Program be continued through at least December 2006. *Brosch Direct, Ex. 291C at 49-50.*

45. Under this proposal, most of the cash proceeds from the Washington share of the Dex gain on sale would be retained by Qwest to provide future revenue credits in lieu of imputation, and thus the vast majority of cash would therefore be immediately available to reduce corporate debt. The amount of the one-time customer bill credit may be characterized as a Material Regulatory Impact under paragraph 5.4(b)(ii) of the Rodney agreement, but it is important to provide some additional compensation to customers to mitigate the risks arising from the sale transaction. The proposed extension of service quality programs would help

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

minimize the risks to service quality that may arise from Qwest's financial distress in the near term. *Id. at 38-40.*

(c) DOD's Direct Testimony Placed an Even Greater Value on the Washington Share of the Gain on Sale.

46. DOD witness Charles King placed an even greater value on the Washington share of the gain on sale. He did so because he disagreed with the attribution of income taxes to the gain and the resulting use of after-tax gain. He also disagreed with the Washington allocation factor, and with the deductions for New Ventures, secondary directories, and non-Qwest listings. *King Direct, Ex. 271 at 23, 26-30.* Accordingly, Mr. King calculated the Washington portion of the gain on sale to be ***BEGIN CONFIDENTIAL XXXXXXXXXXXXXXX END CONFIDENTIAL.***

47. Mr. King recommended that the full Washington share of the gain on sale be distributed to ratepayers in two ways. First, 10 percent of the value should be flowed through to QC's end-user Washington customers in the form of an equal percentage bill credit applied to the local services portion of the customers' bills. The period of distribution should be short, for example, three months. *Id. at 5, 18-20.* Second, the remaining 90 percent of the value should be established as a regulatory liability of QC to its ratepayers. The liability should be amortized over a period of 15 years. *Id. at 5, 21.*

(d) The Stipulation Strikes a Reasonable Balance Between these Positions.

48. The Stipulation strikes a reasonable balance between the positions of Qwest, DOD, AARP, Public Counsel and WeBTEC. It was the result of months of hard negotiations and represents a true compromise by all parties to the Stipulation. It represents a compromise in

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

the amount of the Washington share of the gain on sale to be distributed to ratepayers, a compromise on the way in which the ratepayers' share would be returned to them, and a compromise on certain other non-monetary benefits designed to address specific concerns about the implications and potential consequences of the sale raised by the various customer parties to the Stipulation.

49. The Stipulation provides for up-front bill credits to QC retail customers on a per access line/per channel basis, commencing within 45 days of the closing of the Rodney transaction. These credits would total $67 million and are expected to be worth approximately $29 per access line/per channel. They would represent a direct cash benefit to customers from the sale of Dex. In place of historically contentious imputation adjustments in future rate cases or other regulatory proceedings concerned with QC earnings, the Stipulation calls for a series of fixed annual revenue credits in the amount of $110 million per year for the first four years (2004 through 2007), followed by revenue credits in the amount of $103.4 million per year for the next eleven years (2008 through 2018). *Stipulation, Ex. 2; Brosch Supplemental, Ex. 306 at 3.*

50. *Exhibit 307*, prepared by Mr. Brosch, summarizes and compares the litigation position of Qwest and the litigation position of AARP, Public Counsel and WeBTEC to the monetary benefits that would result from adoption of the Stipulation. *Exhibit 287C*, prepared by Mr. King, also summarizes and compares the litigation positions of Qwest, Public Counsel, and DOD. The compromise nature of the Stipulation is clearly reflected in those exhibits. By Mr. Brosch's calculations, the Stipulation represents a compromise that yields 79 to 85 percent of the total customer economic benefit he recommended in his direct testimony, depending on the discount rate that is assumed. The comparisons also indicate increases in the value of the

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

Stipulation to equal 120 to 129 percent of Qwest's revised rebuttal position.

51. Mr. King explained his view of how the Stipulation comports with DOD's litigation position:

> I conclude that the Agreement represents a reasonable compromise among the parties to this proceeding. The ratepayer benefit of the Agreement … is significant—more than twice that of Qwest's original (1/17/03) position … The Agreement value is nearly half-way between DOD's calculation … and Qwest's revised (4/17/03) position … The Agreement value is nearer to the Public Counsel's position …, than Qwest's revised position. Considering the inevitable risks associated with litigation, I had no problem recommending the acceptance of this compromise by DOD/FEA.

King Supplemental, Ex. 286 at 5.

52. Similarly, Mr. Brosch explained:

> It is obvious, from a review of the evidence submitted by company witnesses and Staff witnesses and by me, that there are a number of disputed issues surrounding how one quantifies the gain: how and if one allocates gain to new ventures, secondary directories, non-Qwest listings, how one calculates the percentage to allocate the gain to the state of Washington and the extent to which it's appropriate to provide for any sharing of the residual Washington gain between shareholders and customers for equitable reasons or under the principles of the Democratic Central Committee or Illinois Pay Telephone cases cited by Mr. Grate.
>
> The stipulation is the result of a process where I believe the parties considered those positions, the litigation risks attendant to them, and reached a compromise.

Brosch, Tr. 1284, ll. 7-23.

ii. <u>The Stipulation Will Protect the Public Interest.</u>

53. The Stipulation will protect the public interest. It provides for customer participation in the realized gain from the sale of Dex through significant one-time customer bill credits, while at the same time securing future rate stability through 15 years of future ratemaking revenue credits. A high percentage of the Washington share of the gain is credited

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

1 to customers overall and these credits are front-loaded and scheduled to extend for 15 years,
2 beyond which time traditional rate-making may no longer provide a vehicle to attribute any
3 further credits to customers. *Brosch Supplemental, Ex. 306 at 5.* The Stipulation represents a
4 reasonable compromise of the positions of the parties and an appropriate resolution of the issues
5 in this proceeding, recognizing, as Mr. Brosch notes, that "approval will provide near and long
6 term tangible benefits to customers, while also allowing Qwest the opportunity to accelerate the
7 repayment of debt with realized net proceeds from the Dex sale." *Id. at 5, l. 21-6, l. 3.*
8

9 **(b) The Stipulation Captures an Appropriate Share of the Gain on Sale for Ratepayers.**
10

11 *54.* The Stipulation captures an appropriate share of the gain on sale for ratepayers
12 for settlement purposes. In fact, the majority of the Washington share of the gain is directly
13 credited to customers under the Stipulation. As noted above, Mr. Brosch calculated the pre-tax
14 Washington share of the gain on sale of Dex to be ***BEGIN CONFIDENTIAL*** ***XXXXXXXXX***
15 ***END CONFIDENTIAL***. Under the Stipulation ***BEGIN CONFIDENTIAL*** ***XXXXXXXXXX***
16 ***XXXXXXXXX*** ***END CONFIDENTIAL***, depending on the discount rate used, would be directly
17 credited to Qwest's Washington ratepayers. *Ex. 307C*. That means that at least ***BEGIN***
18 ***CONFIDENTIAL*** ***XXXXXXXXXXXXXXX*** ***END CONFIDENTIAL*** of the Washington share
19 of the gain value is captured by the Stipulation for ratepayers based on Mr. Brosch's gain
20 calculation. *Id.*
21

22 **(c) The Rodney Transactional Agreements Provide Reasonable Assurances Regarding Continued Directory Publications in Washington.**
23
24

25 55. Qwest has certain directory publishing obligations under Sections 222 and 271 of

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

1 the Federal Telecommunications Act of 1996, and is also subject to the provisions of WAC 480-
2 120-041 and 042 (to be replaced by WAC 480-120-251 on July 1, 2003). In addition, other
3 directory publishing requirements are imposed upon Qwest as a result of WUTC Docket
4 Nos. UT-941464, *et al.* and by Qwest's SGAT. Qwest currently fulfills its directory publishing
5 agreement through a publishing agreement with Dex and through interconnection agreements
6 and listings integration with competitive carriers. QC will continue to fulfill these obligations
7 through the new Publishing Agreement with the buyer of Dex. *Reynolds/Jensen Direct, Ex. 61*
8 *at 10-11.* Mr. Burnett confirmed this approach and explained how Dex will continue to meet
9 these obligations through the new Publishing Agreement. *Burnett Direct, Ex. 51 at 14-15.* No
10 party has challenged the fitness, willingness or ability of Dex to continue to fulfill Qwest's
11 directory publishing obligations under these arrangements.
12
13
14 **(d) The Stipulation Responds to the Concerns of AARP, Public Counsel and WeBTEC and to All Material Public Interest Issues Raised by the Proposed Sale of Dex.**
15
16 **(i) Up-Front Bill Credits Provide An Assured Benefit to All Current Qwest Customers Regardless of Whether They Receive Tariffed, Price-Listed or Contracted Service.**
17
18 56. The Stipulation provides for up-front bill credits totaling $67 million to be
19 applied on a per switched access line/per channel[6] basis. It is estimated that the amount of the
20 bill credit will be approximately $29. As stated by Mr. Brosch in response to a question from
21 Commissioner Hemstad, the up-front bill credits are a critically important part of the Stipulation
22 because they "provide a certain benefit to customers that may ultimately not be the recipients of
23
24
25

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

1 annual revenue credits or your alternatives, the rate base offset." *Brosch, Tr. 1303, l. 22-1304,*
2 *l. 3*. Stated another way, the bill credits provide an assured benefit to all current Qwest
3 customers in Washington regardless of whether they receive tariffed, price-listed, or contract
4 services. The same cannot be said for annual revenue credits or any rate base offset.
5
6 57. Qwest witness Mr. Reynolds makes this point in his direct testimony when he
7 explains that at the point in time that all of Qwest's retail services are competitively classified
8 imputation is essentially terminated, since the Company's rates are no longer set through rate of
9 return regulation. *Reynolds/Jensen Direct, Ex. 61 at 20, l. 18-21, l. 2.* Thus, any rate that is not
10 set with reference to Qwest's earnings through rate of return regulation will not share in the
11 benefit of any annual revenue credit or rate base offset.[7] The up-front bill credits are the only
12 mechanism by which all Qwest customers can participate in sharing the gain on the sale of Dex.
13
14 58. As also pointed out by Mr. Brosch the up-front bill credits "provide for a remedy
15 that is comparable to what is often done with the sale of material assets of a public utility or a
16 business segment of a public utility where there is often a one-time crediting to customers or a
17 very short amortization period over which that gain is conveyed, the benefit of that gain is
18 conveyed to customers." *Brosch, Tr. 1303, l. 22-1304, l. 17; see also, Tr. 1289, ll. 2-6*.
19
20 59. Up-front bill credits have an additional advantage: the risks to ratepayers from
21
22
23
24
25

[6] The intent of the parties to the Stipulation is that the bill credit would be provided to customers based upon access lines and the derived channels for connections that imply multiple line equivalents actually in use by customers. *Brosch, Tr. 1339, ll. 1-4*.

[7] It is not an answer to this concern to say competition will protect customers of competitively classified services unless it can be said with absolute certainty that every customer who purchases Qwest services that have been competitively classified has meaning alternatives and that competition is capable of constraining Qwest's prices at or below the level of what those prices would have been under rate of return regulation, including application of the annual revenue credit or rate base offset. The statutory test for finding effective competition as applied by this Commission has not been so rigorous.

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

any future bankruptcy of QCII or QC are mitigated substantially by them, since the benefit will have already been given to the ratepayers.

60. Finally, it should be noted that up-front bill credits were recommended by Staff and all of the consumer parties prior to the Stipulation. In addition to being a key element of the Stipulation agreed to by Qwest, up-front credits were recommended by DOD (10% of the Washington share of the gain), AARP, Public Counsel and WeBTEC ($147 million), and Staff (10% of the Washington share of the gain). As Staff witness Dr. Glenn Blackmon confirmed on cross-examination, if the Commission were to approve the sale of Dex, part of his alternative recommendation is that the Commission order Qwest to issue a bill credit to customers. *Blackmon, Tr. 1371, l. 24-1372, l. 3*. He testified that he is comfortable recommending an up-front bill credit of 10 percent of the Washington share of the gain. *Blackmon, Tr. 1373, ll. 3-15*.

61. During the hearings the question came up about which Qwest entity would be responsible for paying for the bill credits. While the Qwest entities collectively may share the obligation to provide the bill credits, the practical and economic reality is that only QC has the telephone customer relationship and is in the position to provide the bill credits. It is important to recognize that, except for the case of customers who terminate Qwest service before their credit is exhausted, no cash is actually paid. All that happens is that QC collects 67 million fewer dollars from its Washington customers than it otherwise would over the course of a one, two, or three month time frame. *Brosch, Tr. 1276, ll. 1-6*. This is exactly what happens with imputation. As explained by Mr. Brosch:

> [s]ince cash management tends to be a centralized function, that might mean that dividends upstream to the parent are lower than they would otherwise be or equity infusions into QC by the parent are higher that they would otherwise be,

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

depending upon all the other variables influencing the amount and timing of cash flows within the consolidated group.

Brosch, Tr. 1276, ll. 7-14.

62. With centralized cash management on a consolidated basis and management discretion controlling financial decisions, the Commission should not concern itself with attempted sourcing of cash for customer credits. These credits will have early claim upon the proceeds from the sale of Dex under the Stipulation if it is approved.

(ii) The Stipulation Preserves a Reasonable Level of Contribution from Directory Publishing for Washington Revenue Requirement Protection.

(a) The Revenue Credit Will Provide 15 Years of Rate Protection for Customers by Contributing to Revenue Requirement.

63. The Stipulation preserves a reasonable level of contribution from directory publishing for Washington revenue requirement protection. It provides for most of the Washington share of the Dex gain to be converted into 15 years of future revenue credits that compare favorably to current imputation levels. *Brosch Supplemental, Ex. 306 at 5, ll. 10-13.* In his direct testimony, Mr. Reynolds represented the "current value of existing imputation" to be approximately $103.4 million per year. *Reynolds/Jensen Direct, Ex. 61 at 19, ll. 19-21.* The Stipulation calls for annual revenue credits of $110 million per year for the first four years and $103.4 million for the following 11 years. Although only approximately $85 million is currently embedded in Qwest's present retail rates, the Stipulation would preserve at least the level of imputation that would be calculated today in accordance with existing practice.

64. The parties to the Stipulation believe that 15 years is an appropriate time period over which to extend revenue credits. As Mr. Brosch noted, beyond that time "traditional

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

ratemaking may no longer provide a vehicle to attribute any further credits to customers." *Brosch Supplemental, Ex. 306 at 5, ll. 12-13.* Indeed, given Qwest's pending petition to competitively classify business local exchange services statewide in WUTC Docket No. UT-030614, as well as technological and political changes, it is highly speculative to assume that traditional rate of return regulation will continue in effect for Qwest in Washington for even that period of time. This makes the up-front bill credits even more important for securing the benefits of the sale for ratepayers. Attribution of any of the gain on sale value to periods more than 15 years into the future exposes ratepayers to a substantial risk that those distant future benefits may never be realized through traditional ratemaking procedures.

65. Staff has criticized the 15-year period because it does not match the period of either the publishing agreement or the non-compete agreement, which are 50 years and 40 years respectively. But this criticism fails to acknowledge the fact that the value of the full future stream of revenues to be expected from the directory publishing business is monetized and reflected in the sale price. It is entirely appropriate that this value be flowed to ratepayers in a manner and over a time period which are actually likely to produce benefits for them. As explained by Mr. Brosch:

> Well, the tradeoff, if one looks at what to do with the ratepayers' share of value from the Dex transaction, is to concentrate the benefits in the early years or spread them out over an extended period of years, but if you look at the string of numbers and work with the math, you can see that the more you stretch the benefits into the future, the smaller the benefits can be in any given year. And if one were to attempt to provide firm benefits for 40 or 50 years, the implication of that would be a relatively small revenue credit in each year, even under present value terms, one that could conceivably lead to a conclusion by the company that it should file a rate case sooner, rather than later. And as I said before, that was something we sought to discourage.

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

Q. Do you believe it is good public policy to front-load customer benefits based on the possibility of future deregulation?

A. If one is interested in capturing the value from the Dex gain for customers, yes, I do. Because there's a growing probability that value assigned to distant future years may never be realized by customers.

Brosch, Tr. 1287, l. 19-1288, l. 17.

66. In the view of AARP, Public Counsel and WeBTEC, it is in the public interest to front load the annual revenue credits (i.e., provide for credits that are larger in the first four years than in the remaining eleven years) because of the uncertainty of regulation. By increasing the benefit in the early years, one increases the probability of capturing the value for ratepayers. This structure of the revenue credit portion of the Stipulation was also the result of negotiation, with Qwest willing to increase the revenue credit in the early years in exchange for lower up-front bill credits.

67. In his direct testimony, Mr. Brosch observed the only instance where the sale of a directory publishing agreement was known to have been addressed by the WUTC:

> I am aware of only one instance where the Commission has previously addressed the sale of directory publishing assets, where it approved a rate case stipulation that flowed the entire Washington gain on sale of Contel Corporation's Leland Mast Directory Company to customers over a five year amortization period to compensate for the official publishing rights being conveyed to the buyer of the business.[8] This Contel gain on sale treatment is entirely consistent with past imputation decisions of the Commission that applied the entire value of the publishing asset, above a reasonable return on tangible investment, to telephone ratepayers.

Brosch Direct, Ex. 291C at 83 ll 4-12.

68. It is important to note that the amortization period in that case was over a

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

relatively short period of only five years.

(b) The Revenue Credit Monetizes a Future Income Stream that is Inherently Uncertain, Including Risks from Bankruptcy.

69. The annual revenue credit mechanism provided for in the Stipulation monetizes a future income stream that is inherently uncertain, and may, therefore, represent a net improvement for ratepayers over the existing situation. Qwest asserts that, in the absence of the sale of Dex, there is a significant risk that it will be unable to meet its debt obligations and will be forced to file bankruptcy. If that should happen, there is a significant risk that a bankruptcy court would order the Dex business sold to satisfy the claims of creditors, resulting in the potential loss of the income stream that supports local rates through imputation.

70. Even if the Commission were to disapprove the sale and somehow order Qwest to remain in the directory publishing business through a Washington-only business operation, the expected income stream from such an operation would be highly uncertain. Many of the critical employees and business relationships would likely be lost. There certainly would not be the same economies of scale that exist in the Dex business today available to the Washington-only operation. Furthermore, such an operation likely would be highly vulnerable to competition from Dex itself and from other directory publishers. There is no certainty attached to projections of possible future imputation values at present or optimistically increased annual amounts.

71. By monetizing the future stream of revenues that at least the Buyers expect from

---

[8] Fourth Supp. Order, 10/26/1987; WUTC Cause No. U-87-640-T, Testimony of Merton Lott 10/12/1987, page 5, Exhibit No. (MRL-2) adjustment RA-4.

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

a 14-state integrated directory publishing operation with existing employees and customer relationships and all of the intangible benefit flowing from the association with the incumbent local telephone company, and then flowing most of this monetized value to customers pursuant to the Stipulation, ratepayers are largely protected from these financial and operational risks.

72. As explained by Mr. Mabey, Qwest's bankruptcy expert, the revenue credits under the Stipulation provide a very secure mechanism for the Commission in the event of a future bankruptcy of QCII or QC:

> Now if then the parties agree and the sale of Dex occurs outside of bankruptcy and there's a revenue credit over some period of years, I believe this is a very secure mechanism for the Commission and for QC. Because the sale would have occurred outside of bankruptcy so that the bankruptcy court didn't exercise its broad jurisdiction over it, and a revenue credit is not an agreement requiring QCI to make payments to QC. And, of course, bankruptcy is all about restructuring debts, and so if you avoid the obligation of making payments, you're better off.
>
> And finally, the Commission has its highest strength in rate orders from a federal bankruptcy standpoint. And insofar as the revenue credit is seen as part and parcel of a rate order and the sale of Qwest is consensual so that it occurs outside of bankruptcy and not in bankruptcy, it seems to me that there is substantial protection.

Mabey, Tr. 719, l. 11-720, l. 3.

73. In short, if the sale of Dex is approved and conditions are not imposed that would cause the sale to fail and Qwest to file bankruptcy, the revenue credits provided for in the Stipulation would be secure from any future bankruptcy of QCII or QC because they would likely be seen by a bankruptcy court as a rate order and thus part of the ratemaking process. *Mabey, Tr. 720, ll. 7-14; see also, Tr. 721-727.*

(c) Traditional Imputation Amounts are Not Certain or Predictable and are "At Risk" to Changes in

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25

Directory Publishing Associated with Competition with Internet and Other Media.

74. As it stands today, traditional imputation amounts are not certain or even predictable as we go into the future. In fact, they are at some considerable risk due to changes in directory publishing associated with competition with internet and other media. The revenue credits provided for in the Stipulation monetize a stream of future directory publishing revenues and return assured benefits to ratepayers over a 15 year period, effectively protecting ratepayers from future business risks that could affect the directory publishing business's profitability. As explained by Mr. Brosch, the sale of Dex at this time represents both risk and an opportunity for consumers:

> … I view the sale of Dex, regardless of circumstances, to represent both risk and opportunity to consumers. The sale represents the monetization of an income stream, the conversion of an income stream into a large lump sum of cash that can be used by the company to resolve some of its financial difficulties. The opportunity arises from the fact that the transaction lets us look at this large gain and deal with issues that have been quite controversial in the past, issues associated with directory imputation, ratepayer entitlements to directory imputation, any subsidies that arguably are implied by directory imputation, and it allows us to fix and limit the risk to ratepayers that, if we were to continue to impute the directory publishing business, while consistently profitable in the past, is subject to some risk of business decline or reversal in the future.
>
> As I think about the delivery of a paper publication and the increased usage by the public of alternative information sources, such as the Internet, it occurs to me that there is some risk of displacement of usage and value associated with published directories in the future. I was present when Mr. Kennard testified [in Arizona] about the buyers' perceptions of revenue trends and value, and I recall him saying that, from the buyer's perspective, the expectations regarding growth in revenue were more favorable in the nontraditional portion of the directory publishing business that was being acquired.
>
> So I think it's important to keep in mind what the stipulation brings you is a firm, fixed, known stream of customer benefits, including a very tangible up-front benefit in return for an increasingly at-risk imputation, business-as-usual regulatory situation.

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25

Brosch, Tr. 1310, l. 17-1312, l. 3.

(d) The Stipulation Ends the Contentious Debate Over Directory Imputation.

The Stipulation has another benefit that should not be overlooked. It effectively ends the contentious debate over directory imputation that has been the subject of litigation and lobbying for many years; there will be no further argument about subsidization or constitutional issues. It removes the need to address the issues of whether revenues from secondary directories and non-Qwest listings should be included in imputation, issues raised by Qwest in this proceeding that would certainly complicate future imputation debates. Furthermore, it eliminates the future need for directory publishing financial data to compute imputation values.

(iii) The Customer Protection Measures Provide Additional Near Term Assurances Regarding Customer Services.

75. The sale of the Dex income stream creates future financial risk by substantially reducing the long-term ability of the Qwest consolidated businesses to generate cash flow from operations needed to service debt and attract capital on reasonable terms. Restricted access to capital may also jeopardize the Company's ability to maintain high quality service. Qwest will also have a heightened incentive to increase revenues wherever it can both to replace the Dex income stream and to offset the cost of the revenue credits called for in the Stipulation and because corporate shared costs allocated to QC will likely increase upon the sale of Dex. *Brosch Direct, Ex. 291C at 40-41.*

76. As pointed out by Mr. Brosch, up-front credits represent partial compensation to ratepayers for those increased risks. *Brosch Direct, Ex. 291C at 50, l. 30-51 at, l. 4.* Up-front

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

credits provided for in the Stipulation, although in a lesser amount than originally recommended by Mr. Brosch, would serve the same function. In addition, the Stipulation addresses these increased risks by including a commitment by Qwest that it will not petition to remove the Customer Service Guarantee Program, as outlined in Qwest's Washington tariff WN U-40, Section 2.2.2.B (sheets 27-32) for two years after the sale is approved. Qwest also will commit to address certain Washington Telephone Assistance Program/Tribal Lifeline process and training issues. Additionally, to address concerns about increased pressure to raise rates, particularly for services that will not be protected by the revenue credits, Qwest will commit to work with WeBTEC and DOD on rate stability issues in association with their services. *Stipulation, Ex. 2; Brosch Supplemental, Ex. 306 at 5, ll. 15-18.* Any agreements reached pursuant to this commitment will be submitted to the Commission for its review.

77. These customer protection measures address specific concerns raised by the parties to the Stipulation and provide additional near term assurances regarding customer services. They are a critical element of the Stipulation and help assure that its approval by the Commission would be in the public interest.

78. If the Commission is unwillin t oaccp stip alone, any alternative outcome should by within the framework used by the Stipulation.

C. <u>Adoption of Staff's Positions Regarding Alternative Economic Relief to Customers Creates Unnecessary Risks and No Certainty of Benefits for Customers.</u>

79. Staff's alternative recommendations create a number of significant risks for Qwest's Washington ratepayers with no certainty of benefits accruing to the ratepayers.

i. <u>Staff's Recommended Financial/Capital Structure Constraints and Washington Publishing Contract Requirement, that Are Intended to</u>

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

Protect QC From Its Parent/Affiliates, Are Unproven and Not Fully Developed or Supported by the Record.

80. Staff has recommended in the alternative that if the Commission approves the transaction that it condition its approval on the following:

> 1. That QCII contractually obligate itself as the recipient of the proceeds of the Dex sale to annually compensate QC the amount QC would otherwise realize from the directory function as long as the Publishing and Noncompetition Agreements are in effect and that this QCII – QC contract also provide protections against future QC customer rate increases;
>
> 2. That QCII provide Washington customers a one-time payment equal to 10% of the Washington portion of the sale to compensate ratepayers for additional risks attendant to the Dex sale and that both the annual and one-time payments be treated by QC as operating revenues;
>
> 3. That the Commission impose additional safeguards such as prohibiting any increase in the debt-to-equity ratio above 48.32%, prohibiting any increase in the QC dividend, and otherwise prohibit the lending of QC credit or cash to QCII or QCII affiliates; and
>
> 4. That any changes to the transactional agreements may only be made with Commission approval.

Blackmon Direct, Ex. 370 at 24-26a (revised).

81. These rather high level suggestions are unsupported by any analysis which would detail the specific implementation terms and procedures or any projections of anticipated benefits that would accrue. Beyond the procedural burden on the Commission and interested parties of having to be further involved in monitoring Qwest's conduct to assure compliance, these recommendations were never fully developed with supporting financial or cash flow analyses and have no precedent in Washington. These recommendations are thus speculative and it is questionable whether they would in fact serve as the appropriate tools to achieve the goals Staff seeks to achieve.

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

82. With regard to the contractual obligation proposal, Mr. King testified that in and of itself a contract would not significantly improve the probability that the ratepayers would receive a benefit. *King, Tr. 589, l. 8-14.* A contract between QCII and QC could be voided in the bankruptcy. *King, Tr. 593, l. 18-23.* The Stipulation's revenue credit could provide better protection from a subsequent bankruptcy proceeding than Staff's contractual obligation proposal. *Mabey, Tr. 721, l. 14-21.* Mr. King also criticized Staff's debt-equity condition because the Commission's ability to use a hypothetical capital structure can off-set the risks that QCII might "bleed" QC. *King, Tr. 605-606.*

83. Mr. Brosch similarly testified that Staff's concerns are misplaced since QC is financially consolidated with QCII and it is impractical to assume QC can be financially isolated from QCII. *Brosch, Tr. 1313, l. 8-19.* Further, attempting to provide a revenue credit for the 40 or 50 year terms reflected in the Publishing and Non-competition Agreements would create small revenue credits that could motivate the company to file a rate case sooner rather than later, which the non-Qwest settling parties sought to discourage. *Brosch, Tr. 1287-1288.* Any financial constraints the Commission may wish to consider could be taken up as part of an on-going monitoring of the company's financial conditions or subsequent to any detected deterioration in service quality or investment that might occur. *Brosch, Tr. 1314-1316.*

ii. <u>A Reasonable Balancing of Interests of Consumers and Shareholders is Provided for in the Stipulation that Does Not Expose Ratepayers to the Risks Created by Staff's Proposals.</u>

84. The Stipulation reached between AARP, Public Counsel, WeBTEC, DOD, Qwest and Dex Holdings provides for a reasonable resolution of the issues presented in this docket. The Stipulation balances the interests of ratepayers in receiving compensation for their

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

1 interest in the Dex asset, while allowing the company to utilize most of the immediate cash
2 proceeds to stabilize the company's financial conditions; thereby benefiting the company's
3 shareholders. The Stipulation also has the virtue of protecting ratepayers from the risks
4 attendant to most of Staff's alternative proposals. As Mr. Brosch pointed out in discussing the
5 public interest with Commissioner Hemstad, the Dex sale could be in the public interest even
6 absent the financial difficulty of QCII. *Brosch, Tr. 1310-1312.*
7
8 85. Further, the best means at the Commission's disposal to ensure that QCII does
9 not "bleed" QC to the detriment of Qwest's Washington ratepayers is to carefully monitor
10 service quality and investment and take the steps appropriate, such as the service quality
11 protections that now exist. *Brosch, Tr. 1314, l. 11-21.*
12
13 86. The Stipulation also brings certainty and closure to issues of great importance to
14 Qwest and its customers, allowing the issuance of a non-appealed Order with immediate and
15 long-term customer participation in the majority of the value from the Dex sale transaction,
16 while also allowing Qwest to satisfy its creditors and proceed with the task of improving its
17 financial condition.
18
19 **iii. <u>Dr. Selwyn's Rate Base Off-Set Suggestion Creates More Problems Than It Solves.</u>**
20 87. Although never formally recommended by Staff in testimony, and in fact
21 rejected by Dr. Blackmon in cross examination, considerable discussion regarding a rate base
22 off-set approach occurred during the cross examination hearings. *Selwyn, Tr. 877; Tr. 994-995.*
23 AARP, Public Counsel and WeBTEC respectfully recommend that the Commission reject
24 Dr. Selwyn's rate base off-set approach due to the negative consequences such a remedy would
25

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

have for Qwest's Washington ratepayers and the many unanswered, yet important issues that surround such an approach.

88. Dr. Selwyn suggested upon cross examination by Commissioner Hemstad that his reduction of rate base proposal would be in lieu of the up-front payment provided for in the Stipulation. *Selwyn, Tr. 994, l. 3-13.* Yet Dr. Selwyn also states that from a financial perspective his rate base offset suggestion closely simulates the effect of the revenue credit included in the Stipulation. *Id., l. 14-24.* Dr. Blackmon expressed concern over the rate base off-set approach, "…we did look at it very carefully, but the mechanics of it turned out to be difficult." *Blackmon, Tr. 1476; Tr. 1478-1479.*

89. Mr. Reynolds pointed out during cross examination that an earnings review shortly after a rate base write-down of the magnitude that Dr. Selwyn has suggested could result in a negative revenue requirement for the company. *Reynolds, Tr. 1184.* Qwest witness Dr. William Taylor also identified some of the unintended problems that could be created by such a rate base approach. *Reynolds, Tr. 1214-1215.*

90. Mr. Brosch stated, in a discussion with Commissioner Hemstad, that, "[t]he rate base offset is problematic in a number of ways." *Brosch, Tr. 1304, ll. 11-12.* First, assuming the rate base offset is treated as a regulatory liability, the Commission would have to decide whether it would amortize the liability and, if so, over what period of time. This is important because it would cause the revenue requirement impact to be high in early years and ratably decline to zero in the year amortization ends. This would be entirely inconsistent with the pattern of benefit received by ratepayers through imputation (gradual growth) as well as with the stipulation (levelized with a slight increase in the first four years). *Brosch, Tr. 1304-1305.*

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

The pattern that would result from the amortization would create incentives for annual rate cases, first to implement the large reductions in revenue requirement in the early years for the benefit of ratepayers, then later by Qwest to capture the rapidly and ever decreasing revenue requirement offsets in the later years. *Id.*

91. If there were no amortization, there could be levelized benefits but the regulatory liability would have to be very large to achieve parity with what ratepayers would get under the Stipulation, because the amount of the benefit in any particular year would be limited to only the amount generated by applying the rate of return to the rate base. Without amortization, you are never returning any of the principal amount of the Washington share of the gain. The regulatory liability would effectively be perpetual, which would be problematic from Qwest's perspective. *Brosch, Tr. 1305, ll. 4-18.*

92. As Mr. Brosch explained, one could construct a rate base offset that was not a regulatory liability, but doing so could be highly controversial and present a number of practical issues and concerns, none of which were addressed in this proceeding. For example, the rate base offset might be assigned to the Company's depreciation reserve, but there would be a need to attribute the additional depreciation credits to specific plant asset accounts. Since there is no obvious rational way to do that, there would be a fair amount of judgment and controversy involved. There is a distinct possibility that distortions would be introduced into future depreciation re-prescription proceedings; there might be a much larger depreciation reserve in certain plant accounts that would give rise to a re-prescription of lower accrual rates. Without a coincident rate case to pass the benefit of reduced depreciation expense to customers, a timing issue or problem would be created. *Brosch, Tr. 1305, l. 23-1306, l. 16.* This could also have

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

competitive implications if the depreciation rates found their way into UNE cost studies.

93. Alternatively, specific plant assets could be written down. Again, this would likely be controversial. It could also be "problematic for the company if it triggers an impairment obligation and accrual entries on the company's books that would suggest that there would be a further reduction in the company's consolidated equity balances as a result of the adjustment." *Brosch, Tr. 1306, ll. 19-23.*

94. In conclusion Mr. Brosch stated:

> So I just caution you, there are complications in almost any alternative I can imagine where we try to specify a ratebase off-set, either in terms of intended versus actual pattern of benefits, the timing of rate proceedings to capture those benefits to customers, and specifying exactly how the accounting would work to accomplish the intended regulatory objectives.

Brosch, Tr. 1306, l. 24-1307, l. 6.

95. AARP, Public Counsel and WeBTEC believe the rate base offset proposal has not been adequately explored in this proceeding and undoubtedly would create more problems than it solves. That, coupled with the fact that no party, including Staff, supports it, should lead the Commission to reject the rate base offset approach.

III. CONCLUSION

96. For the foregoing reasons AARP, Public Counsel and WeBTEC respectfully request that the Commission enter an order approving the Stipulation and refrain from adopting any conditions inconsistent with the terms of the Stipulation. It is our position that the Stipulation represents a reasonable outcome for Qwest's Washington ratepayers and is a reasonable outcome that is consistent with the public interest.

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

DATED this 3rd day of July, 2003.

AARP

By: ______________________________
Ronald L. Roseman, WSBA #15396

CHRISTINE O. GREGOIRE, ATTORNEY GENERAL OF WASHINGTON

By: ______________________________
Robert W. Cromwell, Jr. WSBA #24142
Assistant Attorney General
Public Counsel

WeBTEC

By: ______________________________
Arthur A. Butler, WSBA #04678
Ater Wynne, LLP

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25

CERTIFICATE OF SERVICE

I hereby certify that I have this 3rd day of July, 2003, served a true and correct copy of the foregoing document upon counsel of record, via the methods noted below, properly addressed as follows:

Attorneys for Qwest:

Lisa Anderl Qwest Corporation 1600 7th Ave, Suite 3206 Seattle, WA 98290	_____ Hand Delivered _____ U.S. Mail (first-class, postage prepaid) _____ Overnight Mail _____ Facsimile
Mark Reynolds Senior Director - Policy and Law Qwest Corporation 1600 7th Ave, Suite 3206 Seattle, WA 98290	_____ Hand Delivered _____ U.S. Mail (first-class, postage prepaid) _____ Overnight Mail _____ Facsimile
Adam Sherr Qwest Corporation 1600 7th Ave Seattle, WA 98290	_____ Hand Delivered _____ U.S. Mail (first-class, postage prepaid) _____ Overnight Mail _____ Facsimile
Wendy Moser Associate General Counsel Qwest Corporation 1801 California Street, Suite 4900 Denver, CO 80202	_____ Hand Delivered _____ U.S. Mail (first-class, postage prepaid) _____ Overnight Mail _____ Facsimile
Philip Roselli Qwest Corporation 1801 California Street, Suite 4900 Denver, CO 80202	_____ Hand Delivered _____ U.S. Mail (first-class, postage prepaid) _____ Overnight Mail _____ Facsimile
William Brittan Campbell, Bohn, Killin, Brittan & Ray 270 St. Paul, Suite 200 Denver, CO 80206	_____ Hand Delivered _____ U.S. Mail (first-class, postage prepaid) _____ Overnight Mail _____ Facsimile

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

1 Russell Rowe
Campbell, Bohn, Killin, Brittan & Ray
2 270 St. Paul, Suite 200
Denver, CO 80206
3

____ Hand Delivered
____ U.S. Mail (first-class, postage prepaid)
____ Overnight Mail
____ Facsimile

4 ***Attorneys for Dex Holdings:***

5 Brooks Harlow
Miller Nash LLP
6 601 Union Street, Suite 4400
Seattle, WA 98101-2352
7

____ Hand Delivered
____ U.S. Mail (first-class, postage prepaid)
____ Overnight Mail
____ Facsimile

8 Richard Cameron
Latham & Watkins LLP
9 555 Eleventh Street NW, Suite 1000
Washington, DC 20004
10

____ Hand Delivered
____ U.S. Mail (first-class, postage prepaid)
____ Overnight Mail
____ Facsimile

11 ***Attorney for Staff***

12 Gregory Trautman
Attorney General of Washington
13 1400 S Evergreen Park Drive SW
PO Box 40128
14 Olympia, WA 98504-0128

____ Hand Delivered
____ U.S. Mail (first-class, postage prepaid)
____ Overnight Mail
____ Facsimile

15 ***Attorneys for Public Counsel:***

16 Robert Cromwell
Assistant Attorney General
17 Attorney General of Washington
900 Fourth Avenue, Suite 2000, TB-14
18 Seattle, WA 98164
19

____ Hand Delivered
____ U.S. Mail (first-class, postage prepaid)
____ Overnight Mail
____ Facsimile

Simon ffitch
20 Assistant Attorney General
Attorney General of Washington
21 900 Fourth Avenue, Suite 2000
Seattle, WA 98164
22

____ Hand Delivered
____ U.S. Mail (first-class, postage prepaid)
____ Overnight Mail
____ Facsimile

23
24
25

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

1
Attorneys for XO Washington, Inc.:

2
3
4

Rex Knowles Director, Regulatory & External Affairs XO Oregon, Inc. 111 E Broadway, Suite 1000 Salt Lake City, UT 84111	_____ Hand Delivered _____ U.S. Mail (first-class, postage prepaid) _____ Overnight Mail _____ Facsimile

5
6
7

Greg Kopta Davis Wright Tremaine LLP 1501 4th Avenue, Suite 2600 Seattle, WA 98101-1688	_____ Hand Delivered _____ U.S. Mail (first-class, postage prepaid) _____ Overnight Mail _____ Facsimile

8
Attorney for Department of Defense:

9
10
11

Stephen Melnikoff US Army Litigation Center Regulatory Law Office 901 N Stuart Street, #700 Arlington, VA 22203-1837	_____ Hand Delivered _____ U.S. Mail (first-class, postage prepaid) _____ Overnight Mail _____ Facsimile

12
Attorney for American Association of Retired Persons:

13
14
15

Ronald Roseman Directing Attorney Columbia Legal Services 2011 14th Avenue E. Seattle, WA 98112	_____ Hand Delivered _____ U.S. Mail (first-class, postage prepaid) _____ Overnight Mail _____ Facsimile

16
Attorney for Interested Person Richard Finnigan:

17
18
19

Richard Finnigan Attorney at Law 2405 Evergreen Park Drive SW, Suite B-1 Olympia, WA 98502	_____ Hand Delivered _____ U.S. Mail (first-class, postage prepaid) _____ Overnight Mail _____ Facsimile

20
Attorney for United Telephone Company of the Northwest:

21
22
23

Nancy Judy Assistant Vice President, External Affairs Sprint Communications Co. LP 902 Wasco Street, M.S. A0112 Hood River, OR 97031-3105	_____ Hand Delivered _____ U.S. Mail (first-class, postage prepaid) _____ Overnight Mail _____ Facsimile

24
25

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711

1 I declare under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

2

3 DATED this 3rd day of July, 2003, at Seattle, Washington.

4

____

5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25

ATER WYNNE LLP
LAWYERS
601 UNION STREET, SUITE 5450
SEATTLE, WASHINGTON 98101-2327
(206) 623-4711