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 THE UNITED STATES DEPARTMENT OF DEFENSE AND ALL OTHER FEDERAL EXECUTIVE AGENCIES' INITIAL BRIEF

INITIAL BRIEF OF THE UNITED STATES DEPARTMENT OF DEFENSE AND ALL OTHER FEDERAL EXECUTIVE AGENCIES

Robert N. Kittel
Chief

Stephen S. Melnikoff
General Attorney

Regulatory Law Office
Office of the Judge Advocate General
U. S. Army Litigation Center
901 N. Stuart Street, Suite 700
Arlington, Virginia 22203-1837

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Information denoted as CONFIDENTIAL is in **boldface** and surrounded by ***asterisks***.

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INTRODUCTION

The Secretary of Defense, through duly authorized counsel, on behalf of the customer interests of the United States Department of Defense and All Other Federal Executive Agencies (collectively referred to herein as "DoD/FEA"), hereby submits its Initial Brief in the above-captioned proceeding.[1] For the reasons set forth herein, DoD/FEA recommends that the Washington Utilities and Transportation Commission ("the Commission") approve the sale of Qwest Dex, Inc. ("Qwest Dex"), the successor entity for "Yellow Pages" publishing, a wholly-owned subsidiary of Qwest Dex Holdings, Inc., to Dex Holdings, LLC ("Dex Holdings"), a limited liability corporation created to purchase the publishing business, subject to certain conditions as stated below. DoD/FEA's interest in this matter is based on its purchase of large quantities of

[1] It is DoD/FEA's intent to avoid unnecessarily burdening the already voluminous record in this proceeding with argument and legal analysis duplicating those of other parties. To that end, we limit this brief to salient points, focusing where our perspective and expertise can be of meaningful assistance to the Commission.

telecommunications service provided by Qwest Corporation ("Qwest"). In fact, DoD/FEA, with more than approximately 60,000 civilian and 30,000 military employees in Washington, is probably the largest user of telecommunications service (generally and specifically of Qwest) in the state of Washington. Thus, DoD/FEA will be directly and significantly affected by the manner in which the Commission approves, disapproves or conditions any sale of Qwest Dex.

DoD/FEA submits this initial brief pursuant to the Commission's procedural schedule as modified by the Administrative Law Judge's Notice of Extension of Time for Filing Briefs issued June 6, 2003. DoD/FEA is a signatory of the Stipulation and Settlement Agreement ("Agreement") filed with the Commission on May 16, 2003.[2] DoD/FEA supports the Agreement and urges the Commission to issue an order approving and adopting the Agreement's provisions and conditions as full resolution of all the issues in this proceeding. DoD/FEA's position set forth in this matter is best understood in the context of the proceedings that followed Qwest's filing seeking approval of the sale. Accordingly, below we describe the background events in detail and show that DoD/FEA's position is in the public interest, reflecting the evolving nature of this proceeding.

BACKGROUND

This case must be decided in the context of several court decisions that speak directly to the issue of directory publishing by an entity such as Qwest that formerly was

[2] Exhibit 2.

part of the Bell System. Of particular relevance is the order of the United States District Court for the District of Columbia that approved the break-up on the Bell System. In his *MFJ Decision*, Presiding Judge Harold Greene, purposely changing the Department of Justice/Bell System proposed plan of restructuring, ordered that the publishing operations of the Bell System be placed in the local Bell Operating companies (such as US West, the predecessor of Qwest), specifically so that the benefit of any profits from the operation would be used to reduce local service rates:

> All those who have commented on or have studied the issue agree that the Yellow Pages provide a significant subsidy to local telephone rates. This subsidy would most likely continue if the Operating Companies were permitted to continue to publish the Yellow Pages.
>
> The loss of this large subsidy would have important consequences for the rates for local telephone service. . . . This result is clearly contrary to the goal of providing affordable telephone service for all Americans.[3]

Qwest cites the *MFJ Decision* with approval, but then argues that this case is dated and no longer of consequence, because Qwest faces competitive pressures in connection with its provision of local service.[4] Leaving aside the question of whether Qwest faces effective competition for local service in Washington, DoD/FEA believes that the underlying basis for that part of the *MFJ Decision* is controlling and mandates that any conflicting views about the propriety of assigning the gain on the sale be resolved in favor of ratepayers.

Independently, another very relevant decision is that of the Supreme Court of Washington in *US West v. WUTC*.[5] That case acknowledged that Qwest's predecessor

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[3] United States v. AT&T, *Modification of Final Judgment*, 552 F. Supp. 131, 194 (D.D.C. 1982), *aff'd*, 460 U.S. 1001 (1983) ("*MFJ Decision*") (footnote omitted).
[4] Exhibit 110, pp. 9-10.
[5] US West Communications, Inc. v. Washington Utilities and Transportation Commission, 134 Wn.2d 74, 949 P.2d 1337 (1997) ("*US West v. WUTC*").

had transferred the publishing operation to an affiliate without adequate compensation and held that the Commission had jurisdiction to impute revenues from the unregulated publishing business to the regulated company for the purposes of setting rates.[6] The court also noted, however, that "…the [revenue] imputation is not necessarily permanent, and the Commission's prior orders show that when the Company has shown it has received fair compensation from the affiliate for the value of the asset it transferred, imputation may cease."[7] Finally, the court quoted approvingly from a court's decision affecting another Qwest jurisdiction that the shareholders of the parent company had borne no "significant risk" in developing the publishing business and that the public interest in those assets was "beyond dispute".[8]

Finally, DoD/FEA notes the Commission's precedent in considering asset transfers of regulated companies. The *Centralia* case cited by parties in this proceeding (which is unique in that the asset transfers in this proceeding are not physical assets on the utility's books) summarized the approach as follows:

> That is, we will deny the application if the transaction is not consistent with the public interest, but will approve it, if the applicant demonstrates that the transaction, on balance, at least does not harm. To reach this determination, we have, in the past and in this case, considered and balanced four principles. The four principles address: (1) the rates and risks faced by ratepayers, (2) the balance of interests among customers, shareholders, and the broader public, (3) the effect of the transaction on competitive markets, and (4) protection of the interests of Washington ratepayers.[9]

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[6] 134 Wn.2d at 95, 949 P.2d at 1348.
[7] 134 Wn.2d at 102, 949 P.2d at 1352.
[8] 134 Wn.2d at 100, 949 P.2d at 1351.
[9] In the Matter of the Application of Avista Corporation for Authority to Sell its Interest in the Coal-fired Centralia Power Plant, Docket Nos. UE-991255 *et al.*, *Second Supplemental Order; Order Approving Sale with Conditions* (March 6, 2000), para. 29 (footnote omitted) ("*Centralia*").

HISTORY OF THE PROCEEDINGS

By a filing dated September 3, 2002, Qwest notified the Commission of the proposed sale of Qwest Dex by Qwest's parent company, Qwest Communications International, Inc. ("QCI"), and asked that the Commission issue either an order stating that it had no jurisdiction over the transaction or, in the alternative if the Commission did assert jurisdiction, an order approving the sale and addressing the financial consequences thereof. Following the receipt of petitions to intervene, the Commission held a prehearing conference on October 8, 2002 to formulate the applicable issues to be addressed, allow interested parties to intervene and set procedural dates as needed. DoD/FEA, among others, was granted party status at the conference. Following that conference, Administrative Law Judge Dennis J. Moss issued an order that included, *inter alia*, a procedural schedule. As required by the schedule, Qwest filed its direct case exhibits and testimony on January 17, 2003.

In their direct testimony, Qwest witnesses described the current and proposed operation of Qwest Dex and the relationships between Qwest, QCI and the publishing business.[10] Witness George Burnett stated that after the sale, Qwest Dex will continue the publishing operation "using the assets, people and intellectual capital it uses today."[11] Other witnesses testified as to the need for the sale, asserting that a sale was "critical" to the continued viability of Qwest and QCI.[12] In their view, without a sale of Qwest Dex,

[10] Exhibit 51
[11] *Id*., p. 16.
[12] Exhibit 171, p. 2; Exhibit 172, pp. 20-1.

its parent QCI would default on its debt obligations and possibly incur bankruptcy.[13] Qwest stated that the sale will improve QCI's financial stability for several years, address liquidity concerns and allow QCI to focus on its telecommunications business.[14] The Qwest Dex purchaser, Dex Holdings, presented a witness, William Kennard, who described that company's plans for continuing the directory publishing operation and its qualifications to do so. Mr. Kennard also recommended that the Commission not try to independently determine the value of the publishing operation.[15]

Other Qwest witnesses addressed the issue of how to treat the gain on the sale of the Qwest Dex publishing operation. Witness Philip Grate described legal precedent concerning the treatment of asset sales by regulated companies, and reviewed the history of the publishing operation of QCI, its predecessors and affiliates. He concluded that ratepayers bore the risk of loss on the company's publishing operations assets from around 1922 until the end of 1983, after which the assets had been transferred from the regulated company to a separate subsidiary.[16] In his view, however, the majority of the gain on the sale of Qwest Dex represents goodwill built up over many years, and neither Qwest nor QCI has been allowed to earn a return on that goodwill. Because ratepayers did not bear any risk of loss as to the goodwill, he stated, they are not entitled to any of the gain attributable to goodwill. As to the gain associated with the sale of assets, however, he concluded that ratepayers should receive no more than 50% of the asset sale proceeds.[17]

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[13] Exhibit 171, p. 3.
[14] *Id.*, p. 11.
[15] Exhibit 241, pp. 11-2.
[16] Exhibit 101, p. 24.
[17] *Id.*, p. 25.

Qwest witness Mark Reynolds, adopting the pre-filed testimony and exhibits of Theresa Jensen, testified that the sale of Qwest Dex does not require Commission approval at all, citing the absence of any assets associated with the publishing operation in Qwest's rate base.[18] If the Commission does believe that it must address the sale, however, he recommended that the Commission approve the pass-through transfer of Qwest Dex without conditions that "would defeat the purpose of the transaction or impose any new liabilities."[19] He stated that the Commission should address the financial disposition of the sale, recommending that the Commission continue to impute revenues from the publishing business to the regulated business "until the ratepayer interest in the sale proceeds is satisfied."[20] Qwest prepared a preliminary estimate of the gain from the sale, but removed therefrom the portion of the gain associated with lines of business other than those devoted to local exchange service, such as secondary directories, which resulted in the removal of about 30% of the total.[21] He then determined that the portion of the gain attributable to Washington is 17.44%, using state directory revenues as the allocator.[22] In the interest of "balancing ratepayer and shareholder interests", Mr. Reynolds proposed to share 50% of the gain thus calculated with Washington ratepayers.[23] The imputation of revenues that currently exists would continue for five

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[18] Exhibit 61, p. 21. In light of the agreements that were reached among the parties in this proceeding, excluding staff, DoD/FEA will not further address the need for Commission approval of the Qwest Dex sale, as Qwest has in effect conceded that issue.
[19] *Id*., p. 23.
[20] *Id*., p. 24.
[21] *Id*., p. 33
[22] *Id*.
[23] *Id*., p. 34.

years, and then cease.[24] Thus, the estimate of the Washington ratepayers' share of the gain associated with Qwest's Direct Case position was quantified as *****-----*****.[25]

The Commission's staff and intervening parties filed responsive testimony on March 18, 2003. All parties opposed Qwest's proposal as to the benefits that ratepayers would receive thereunder. Staff witness Dr. Glenn Blackmon concluded that the Qwest Dex sale is not in the public interest and should be rejected because:

- Qwest customers would be better off without the sale because Qwest proposed only a limited continuation of the revenue imputation; and
- The transaction violates a "fundamental public policy that the services of captive customers should not be used to subsidize competitive ventures or insulate companies from competitive risks."[26]

Staff opposition to the sale was based in part on the fact that the terms thereof prohibit Qwest from publishing a directory itself or using another directory publisher for decades, thus abandoning a source of potential revenues. In Dr. Blackmon's view, the risk of bankruptcy -- if bankruptcy is even a risk at all -- does not justify the sale under the stated terms, and in any event the bankruptcy of QCI does not necessarily mean that Qwest would also declare bankruptcy. Both he and staff witness Kathy Folsom described the bankruptcy of Enron and its ownership of a non-bankrupt regulated company to support their position that QCI's bankruptcy would not necessarily adversely impact Qwest's

[24] *Id*., p. 41.
[25] Exhibit 287C, line 5. The quantifications of "ratepayers' share" of various proposals discussed in this Brief represent the present value dollars of those benefits.
[26] Exhibit 370, p. 4.

ratepayers.[27] In the event that the Commission approves the sale, however, Dr. Blackmon recommended that the Commission:

- Require QCI to contract with Qwest to pay Qwest annually, for the duration of the publishing and non-competition agreements, the expected amount that Qwest might otherwise receive from the directory publishing operation;
- Compensate Washington ratepayers with a one-time payment of 10% of the Washington portion of the sale proceeds;
- Prohibit Qwest from taking certain actions as to increasing the debt ratio or dividend, or lending cash to QCI or an affiliate without prior Commission approval; and
- Require prior Commission approval of any changes to the publishing agreement or any other agreement involving Qwest.[28]

The staff also presented testimony by Dr. Lee Selwyn, a consultant, who stated that the sale price for the Qwest Dex publishing operations was significantly lower than its market value, and that this transaction was publicly known to be a "distress sale".[29] He testified that Qwest was financially healthy and that it is the unregulated operations of QCI that have caused the financial crisis which Qwest's witnesses described.[30] Thus, he recommended that if the Commission permits the sale, the Washington share must be

[27] *Id*., pp. 16a-19; Exhibit 431.
[28] Exhibit 370, pp. 24-26a. These recommendations were made in a revision to Dr. Blackmon's testimony dated May 14, 2003. He modified his prior recommendations as to conditions for the sale should the Commission approve it, including a recommendation that QCI pay the entire Washington portion of the sale proceeds to Qwest, to be recorded on Qwest's regulated books.
[29] Exhibit 311, pp. 17; 24-38.
[30] *Id*., pp. 17-22.

based on a valuation greater than the $7.05 billion "distress price".[31] Dr. Selwyn also contested the risk analysis set forth by Qwest witness Grate, including his conclusion that the bulk of the sales price constituted "goodwill", and concluded that any goodwill in the publishing business has been an asset of Qwest, not the publishing business.[32] Rather than being "goodwill", as Qwest claims, nearly all of the sales price is, according to Dr. Selwyn, "identifiable intangibles and their directly resulting 'Franchise Value' that this Commission has previously determined to constitute 'regulatory assets' beneficially belonging to Qwest…."[33] He rejected the exclusion of certain publishing activities in the determination of the sales gain allocated to ratepayers.[34] Finally, he agreed with Dr. Blackmon that Washington ratepayers are entitled to 100% of the Washington share of the Qwest Dex gain.[35]

DoD/FEA presented testimony by Charles King, who stated that end-user ratepayers are entitled to guaranteed compensation "for giving up the benefits of this valuable asset in order to rescue their telephone utility's parent company."[36] Because ratepayers have borne the entire risk of loss from directory publishing operations, they are entitled to compensation for the full gain in value of that business, including operations such as secondary directories.[37] Mr. King also noted that the "risk analysis" that Qwest witnesses Grate and Reynolds presented omitted the highly relevant fact that

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[31] *Id.*, p. 40.
[32] *Id.*, p. 73.
[33] *Id.*, p. 74.
[34] *Id.*, pp. 97-108.
[35] *Id.*, p. 110.
[36] Exhibit 271, p. 3.
[37] *Id.*, pp. 4-5; 14-16. Mr. King stated that the criteria for deciding which activities should be included in the calculation of the ratepayer share of the gain are: (1) whether the activity is related to directory publishing, and (2) whether the activity contributed to the gain. *Id.*, pp. 24-5. He agreed with Qwest that the LCI deduction from the gain is appropriate because that is an equipment leasing operation unrelated to the directory publishing business. *Id.*, p. 25.

the publishing operations/assets were placed with Qwest's predecessor at the divestiture of AT&T specifically so that the revenues therefrom would subsidize the rates for local telephone service.[38]

Mr. King recommended that the Commission flow through to end-user ratepayers, in the form of a bill credit, 10 percent of the Washington value of the gain (including the gain attributable to most operations that Mr. Reynolds excluded), and establish the remaining 90 percent as a regulatory liability to be amortized over 15 years.[39] Thus, Washington ratepayers would receive in the future the benefit of the annual amortization (as a revenue imputation) and the rate base offset of the remaining unamortized liability.[40] Mr. King used the share of the earnings, rather than revenues, attributable to Washington to calculate the share for Washington ratepayers because the "driver" of the gain is earnings, not revenues.[41] Mr. King also rejected the use of a post-tax gain, as Mr. Reynolds recommended, because, *inter alia*, QCI is unlikely to pay any tax on the gain from the Dex sale.[42] Mr. King quantified the share of the gain that should be returned to Washington ratepayers as *****-----*****.[43] Mr. King also recommended that the Commission require that the sale agreement impose on the new Qwest Dex publisher an obligation to include "blue pages" that provide listings for government agencies in all primary directories.[44]

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[38] *Id.*, pp. 9-11, *citing MJF Decision,* 552 F. Supp. at 194.
[39] *Id.*, pp. 5-6.
[40] *Id.*
[41] *Id.*, p. 28.
[42] *Id.*, p. 29.
[43] Exhibit 287C, line 1. See fn. 25, *supra*.
[44] *Id.*, pp. 7-8.

Michael Brosch presented testimony on behalf of the Washington Attorney General -- Public Counsel Section, AARP and Washington Electronic Business & Telecommunications Coalition ("WeBTEC") (collectively, "Public Counsel"). Mr. Brosch recommended that the Commission use the Washington portion of the gain on the sale (absent the LCI and New Ventures portions) to secure a long-term annual revenue credit of $103.4 million that would replace the existing imputation of revenues, with the excess of the gain ($147 million) after this transaction credited to ratepayers on their bills.[45] He also recommended that the Commission take steps to ensure that service quality does not decline after the sale.[46] Mr. Brosch did not adjust the negotiated sales price even though, he stated, evidence showed that the price was too low, and he reported a pre-tax gain.[47] His estimate of the Washington ratepayers' share of the gain was *****-----*****.[48]

Qwest filed rebuttal testimony on April 17, 2003. A bankruptcy expert, Ralph Mabey, a former Bankruptcy Judge, explained the consequences of a QCI bankruptcy filing on Qwest and its ratepayers. Among other things, he stated that, if the sale of Qwest Dex was not consummated and QCI subsequently declared bankruptcy, the bankruptcy court would have jurisdiction over the assets and stock of Qwest Dex. Furthermore, he stated that the proceeds of a bankruptcy sale of Qwest Dex would be available to pay QCI's creditors, and that the bankruptcy court had the ability to enjoin efforts by a state commission to impute the sale value to the regulated utility.[49] Qwest

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[45] Exhibit 291, pp. 9-10; 65-7.
[46] *Id.*, pp. 58-9.
[47] *Id.*, pp. 62-4.
[48] Exhibit 287C, line 2. See fn. 25, *supra*.
[49] Exhibit 211, p. 8.

witness Peter Cummings asserted that the Qwest Dex sale price is not the result of a distress sale, and argued that the Commission should not impose on Qwest the conditions that the Staff advocated.[50] Witness Grate responded to testimony as to who is entitled to gain on the sale of Qwest Dex and whether the Commission should use a post-tax approach to valuation of the gain.[51] Other witnesses responded to intervenors' testimony. Significantly, however, Qwest modified its proposal for distributing part of the gain to Washington ratepayers, in part because Qwest had entered into settlement agreements in Arizona and Utah regarding the Qwest Dex sale. The revised proposal provided to Washington Qwest ratepayers "… the current value of the existing imputation of $103,370,843 as an adjustment to revenues for the regulated results of operations for a period of 10 years after the sale is approved."[52] The use of 10 years, rather than the previous proposed 4.5 years, would result in *****-----***** of the gain being made available to ratepayers.[53] Qwest's revised proposal, however, did not propose any up-front payment to ratepayers.

THE SETTLEMENT AGREEMENT

Prior to commencement of evidentiary hearings, the intervening parties and Qwest entered into the Agreement that would settle all the issues in this proceeding. The Commission's staff did not sign the Agreement. The Agreement provides for up-front

[50] Exhibit 178, pp. 12-21.
[51] Exhibit 110.
[52] Exhibit 64C, p. 18.
[53] Exhibit 287C, line 4. See fn. 25, *supra*.

bill credits totaling $67 million to end-user customers within 45 days of the sale closing. The current revenue imputation procedure would be replaced by a series of fixed annual revenue credits starting with $110 million in 2004 and then $103.4 million starting in 2008. After 2018, the annual revenue credits would cease.[54] The present value of the Agreement terms is $942 million.[55] This amount is greater than two times the original Qwest position, and nearer to the Public Counsel's original position than to even Qwest's Rebuttal Testimony revised position.[56] The Agreement represents 87% and 77% of the original positions of Public Counsel and DoD/FEA, respectively.[57] The Agreement also contains commitments by Qwest concerning customer service guarantees, the telecommunications assistance program, lifeline and link-up programs, government listings, and discussions about contract rate stability.[58]

Qwest, Dex Holdings, Public Counsel and DoD/FEA witnesses filed testimony supporting the proposal. Staff witnesses Blackmon and Selwyn filed testimony opposing the settlement. Witness Blackmon explained that the Staff does not agree with the premise that a failure to sell Qwest Dex would lead to QCI's bankruptcy, or that bankruptcy would necessarily adversely affect Qwest customers. The Staff also objected to the amount and duration of revenue credits, and the exclusion of terms regarding

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[54] Exhibit 2, pp. 3-5.
[55] Exhibit 287C, line 3. See fn. 25, *supra*.
[56] Exhibit 286, p. 5.
[57] For convenience, Exhibits 287C (Comparison of Ratepayer Benefits) and 288C (Graphic presentation of Comparison of Ratepayer Benefits) are attached to this Brief as Attachments I and II, respectively.
[58] Exhibit 2, pp. 6-7. At this time, Qwest's commitment to discuss contract rate stability provisions extends only to DoD/FEA and WeBTEC. *Id*., p. 7. This provision in the Agreement, however, does not preclude Qwest from entering into similar discussions with customers who did not sign the Agreement, and it in no way obligates the Commission to approve any such rate stability provisions that the parties agree to in such future discussions. Thus, the provision does not require specific action by the Commission at this time. To the extent that such discussions are fruitful, the resulting contract rate stability provisions would be filed with the Commission upon execution. At that time, the parties can bring to the Commission's attention the benefits of those provisions and recommend further action in this regard.

Commission oversight of directory publishing activities. Witness Selwyn also criticized the Agreement because the revenue credit is not backed up by actual revenues and earnings, which might adversely affect Qwest in the future.[59] Dr. Selwyn also stated that the Agreement is not, in his view, competitively neutral.[60]

THE COMMISSION SHOULD ISSUE AN ORDER THAT CONTAINS THE TERMS OF THE AGREEMENT

DoD/FEA has set forth the history of filings in this proceeding in detail to highlight the extensive record, the wide variety of positions of the parties, and the complexity of the issues that must be resolved. This is not a rate case in which the fundamental issues are the company's overall revenue requirement and the manner in which ratepayers should bear that requirement -- issues for which extensive precedent exists. This proceeding raises many significant, novel policy issues for which there is not necessarily clear Commission or judicial precedents. Parties are in disagreement as to both policy matters and ratemaking issues. To resolve this proceeding, the Commission would, absent settlement, be required to address a multitude of highly contentious matters such as:

- To what extent, if any, did Qwest activities cause the financial difficulties that led to the sale, and how is that matter relevant to the proceeding;
- Should the Commission approve any sale of the publishing operations at this time;

[59] Exhibit 363TC, pp. 5-7.
[60] *Id.*, pp. 9-11.

- Should the Commission approve a transaction in which Qwest agrees not to enter into the directory publishing business for an extended period;
- What is the value of the Qwest Dex business and to what extent does that value differ from the sales price;
- To what extent is the gain on the sale attributable to ratepayers generally;
- Are there portions of the gain that do not "relate" to directory publishing such that ratepayers are not entitled to that part of the gain;
- Because the publishing business is a multi-state operation, how should the allocator of the overall gain to Washington be calculated;
- How should federal income tax liability be taken into account in determining the gain; and
- To the extent that ratepayers are entitled to some or all of the gain realized on the sale, how should they be compensated (bill credit/payment, revenue imputation, rate base adjustment or a combination of these) and in what time frame (up-front, continuing or a combination of these) and for what period of time?

DoD/FEA's believes that a review of the extensive record herein and applicable precedent is convincing that Qwest's original position regarding allocation of a portion of the Qwest Dex sale proceeds to Washington ratepayers failed the "no harm" test, ignored the *MFJ Decision's* rationale for allowing Qwest's predecessor to "hold" for ratepayer benefit the publishing operations and assets, and was contrary to the import of *US West v. WUTC*. DoD/FEA acknowledges, however, that under *US West v. WUTC*, Washington ratepayers could not reasonably expect to receive the benefits of the revenue imputation

forever, should QCI decide to sell the publishing operations and provide fair compensation. DoD/FEA's disagreement with Qwest's initial and revised proposals also was based in part on Qwest's failure to recognize and address as an underlying initial premise that the sale of the valuable publishing asset was not caused by Qwest or its ratepayers. As Mr. King put it:

> The management of QCI and, by extension the shareholders of QCI, bear the entire responsibility for the precarious financial condition that requires QCI to sell Dex. It was they who allowed QCI to become so indebted that it faces the possibility of bankruptcy.[61]

In fact, recent events have confirmed that it is Qwest that is providing for the viability of the QCI operation. QCI has been able to raise nearly $2 billion in loans to cover approaching debt maturities. It is generally accepted and reported that this is twice the amount than originally planned, and that QCI was able to successfully raise the funds due in part to "…the strength of the assets at Qwest Corp, the borrower in the transaction and the Qwest unit that houses the former Baby Bell US West."[62] Clearly, ratepayers who are keeping the parent company out of bankruptcy should not see the benefits of their contribution provided primarily to stockholders (who were in a position to prevent the financial crisis).

The agreement by Qwest to the terms set forth in the settlement Agreement constitutes a significant step in eliminating the concerns that DoD/FEA had as to the manner in which ratepayers in Washington would be compensated for the sale of the publishing operations as well as providing an immediate and certain resolution to the

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[61] Exhibit 271, p. 8.

[62] Wall Street Journal, June 9, 2003, p. B8, of which DoD/FEA requests the Commission take official notice.

matter. That certainty allows a significant share of the gain from the transaction to benefit ratepayers, as well as stabilize the QCI financial situation. Clearly, that Agreement does not -- as is the case with settlements generally -- fully reflect DoD/FEA's original position on the merits. As demonstrated in Mr. King's Supplemental Testimony, Exhibit 286, the ratepayer benefits derived from the Agreement lie between (and closer to) the higher values originally advocated by DoD/FEA and Public Counsel and the lower amounts proposed by Qwest. The Agreement terms, however, inject into this highly contested proceeding an element of certainty and immediacy that did not previously exist. In DoD/FEA's view, the subject settlement is a "compromise" and an "appropriate balancing of benefits and risks for both the company and ratepayers."[63] Mr. King acknowledged that alternative resolutions exist to those included in the Agreement. Individually such alternatives may have both advantages and disadvantages compared to the Agreement's provisions. However, Mr. King endorsed the Agreement as the comprehensive resolution with its advantage of minimizing the overhanging risk to benefits being realized by ratepayers.[64]

First, the Agreement provides for a substantial up-front payment, contrary to Qwest's initial desire to avoid such an approach. Thus, notwithstanding possible future changes in the company's financial condition or the nature of regulatory oversight, ratepayers have obtained a tangible and immediate benefit from the sale. Moreover, the parent company obtains the benefit of immediate and substantial sale proceeds to be used to reduce its debt.

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[63] Exhibit 286, p. 3.
[64] Transcript, pp. 615-6.

Second, the Agreement eliminates any uncertainty as to whether and how much future ratepayers will continue to receive benefits from the publishing operations. As Mr. King testified, it is possible that if the directory publishing remained a QCI/Qwest operation but the Yellow Pages portion lost value due to intervening events (such as increased competition in the publishing market), the revenue imputation would decline but the regulated company would continue to be responsible for producing the money-losing White Pages.[65]

Third, although the possibility of a QCI bankruptcy appears to be less now than when this proceeding began, the retention of a valuable publishing operation by QCI as a bankrupt company would be in doubt, and uncertainty exists as to what conditions the bankruptcy court would impose if the publishing operation were sold as part of any bankruptcy proceeding. The risk that a forced sale of the publishing operation would leave ratepayers with little or no benefits at all is accordingly removed by the Agreement.[66] Judge Mabey believed that the Agreement was structured to best preserve the continuation of the benefit flow to ratepayers notwithstanding any subsequent bankruptcy of QCI. Unlike the guarantee of future direct payments, the guarantee of future revenue credits (as contemplated by the Agreement) is probably not reachable by a bankruptcy proceeding.[67] Dr. Kalt noted that this protection and certainty made the Agreement's form of gain distribution, revenue credits, more valuable to ratepayers.[68]

[65] Transcript, p. 611.
[66] Transcript, p. 613.
[67] Transcript, pp. 718-20; 738-9.
[68] Transcript, pp. 763-4.

Finally, the Agreement provides finality to the issue of imputation that has been in contention in Washington for a considerable period. As DoD/FEA noted above, it is less than clear that the Commission could continue the imputation of publishing operation revenues indefinitely, given among other events the court's decision in *US West v. WUTC*. The existence of the revenue credits set forth in the Agreement, like imputation, has significant tangible benefits for ratepayers. The revenue credits would not only benefit ratepayers in the event of a rate case during its existence, but that credit could also, as Mr. King testified, "stave off" a rate case and ensure that rates are not increased for its duration.[69]

DoD/FEA's position with regard to the settlement was well summed up by its witness during his oral testimony. On redirect examination, Mr. King testified as follows:

> My recommendation is to adopt the settlement, and the reason is that the settlement is a -- is a done deal, that there is no hanging risk over the realization of return of benefit to ratepayers. Why? Because the company has accepted the level of ratepayer benefit that is embodied in the settlement. Any more generous offer to ratepayers -- and I will concede that there are good arguments for a more generous flow for ratepayers, certainly I advocated one myself in my response testimony. But any other alternative that flows more money to the ratepayers is likely to encounter the company's opposition, and that immediately puts it at risk. The company, in this case, has accepted the level of -- accepted a level of ratepayer benefit. That, in and of itself, makes the settlement a low-risk proposition, which is why I support it.[70]

[69] *See* Transcript, pp. 614-5.
[70] Transcript, p. 616.

STAFF's RECOMMENDATIONS ARE EXTREMELY RISKY AND HAVE UNCERTAIN PROSPECTS

The sole holdout against the Settlement Agreement is the Commission's Staff. The Staff's opposition to the Agreement appears to be based on its belief, as expressed by Dr. Selwyn, that the proposed sale "makes ratepayers worse off than a -- than the status quo."[71] That "status quo", however, appears to be Staff's belief that revenue imputation would continue indefinitely (even if the Qwest Washington Yellow Pages publishing operation were assumed by another entity) at the level that now exists, if not higher. Even Dr. Selwyn concedes that such an assumption is "something that one can only speculate about."[72] Moreover, comparing the terms of the Agreement with the manner in which the Dex Yellow Pages profits were treated in the past is not, as Chairwoman Showalter noted, a valid comparison of the Agreement and the "status quo."[73] No matter what the Commission does, it is clear that the Qwest Dex business will not remain as it now exists. Thus, it is essential that the Commission's deliberations as to the Staff's proposed resolution of the issues not focus on the benefits that Washington ratepayers gained in the past from the Qwest Dex operations, but rather include an assessment of the risks inherent in the Staff's opposition to the Agreement and in its own proposals. Such an analysis and focus on the real "status quo" make the Agreement even more attractive and reveal that the Staff's position and proposals are extremely risky and have uncertain prospects.

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[71] Transcript, p. 976.
[72] *Id*.
[73] Transcript, pp. 986-7.

Staff witness Blackmon testified to his belief that the sale does not provide enough compensation to ratepayers and that the Commission should reject the sale rather than approve it on the terms agreed to in the Agreement.[74] If the Commission approves the sale, Staff recommends a much larger up-front payment and a continuing contractual commitment by QCI, Qwest's parent, for annual payments larger than those proposed in the Agreement and lasting for 40 years, the duration of the Dex publishing agreement.[75]

During examination by Chairwoman Showalter, Dr. Selwyn conceded that disapproval of the sale by the Washington commission would probably not result in the cancellation of the entire Dex sale. More likely, it would result in Washington's QCI/Qwest directory operation becoming a stand-alone (possibly only a "shell") enterprise that publishes directories either independently or through arrangements with another publisher that already has expertise and the scale at a level that would be comparable to Dex. The sale of Qwest Dex to Dex Holdings could probably be restructured, carving out Washington's directory "operation", to establish Dex Holdings the incumbent publisher of directories in 13 of the 14 states in Qwest's service territory. However, the result would also create Dex Holdings as a possible strong competitive threat to the stand-alone operation of a Washington Qwest directory entity.[76] If the remainder of the Qwest Dex sale cannot be restructured, another, more far reaching, risk and possible "harm" is introduced. Without the proceeds available from this portion of the Qwest Dex sale, at the very least, more "stress" is applied to the QCI financial condition, adding to the possibility of a bankruptcy filing, with all its attendant fallout,

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[74] Exhibit 421C, p. 1.
[75] *Id.*, p. 4.
[76] Transcript, pp. 975-7.

uncertainties and impact on Qwest and its ratepayers, not just confined to Washington state.

It became obvious during Dr. Selwyn's examination that this scenario is fraught with risk. Dr. Selwyn conceded that there would be no way the Commission could guarantee that the employees currently associated with Dex in Washington would stay with the Qwest directory enterprise.[77] Given that Dex would not be bound by a non-compete clause, there would be nothing to stop it from seizing the existing Washington customer base and publishing directories in competition with Qwest.[78] Nor would there be any way to prevent other publishers, such as Verizon, from invading Qwest's directory market.[79] Obviously, such a weakened Washington stand-alone Qwest directory operation would be at least a diminished benefit, if not an actual "harm", to Washington ratepayers.

Dr. Selwyn also conceded that one-fourteenth of Dex is not as valuable as the entire company. As he acknowledged:

> And you know, clearly you can envision various outcomes where you in some cases win, in some cases lose, and I'm not in any sense proposing that the Commission engage in a game of chicken with Qwest or with Dex Holdings in this case, but, I mean, there's no question that the story is different given the fact that the other 13 states are going to happen.[80]

If what Dr. Selwyn states is correct, then a disapproval of the sale by the Commission[81] would be an extremely risky course of action, detrimental to Washington

[77] Transcript, pp. 977-8.
[78] Transcript, p. 981.
[79] Transcript, p. 983.
[80] Transcript, p. 985.
[81] Another scenario--should the Commission so change the structure of the Agreement as to cause Qwest to cancel the Qwest Dex sale--likewise, is not in the public interest. Such an outcome would have the same detrimental effects on Washington ratepayers, and possibly beyond, as a Commission's direct disapproval of the sale.

ratepayers, and one that would likely result in a much weaker, more vulnerable, and less profitable directory operation in Washington than that which has existed in the past or which would exist if Dex remains intact as a 14-state operation. As noted above, there are more far reaching potential impacts from a failure of the Qwest Dex sale to close.

If the Commission does approve the contract, Staff recommends that stringent conditions be imposed on the sale, which DoD/FEA has described in a prior section.[82] Additionally, Staff believes that some of the $500 million that QCI has admitted setting aside for regulatory payments in connection with the sale should be flowed through to ratepayers.[83] Dr. Blackmon also argues that "affiliate interest" conveys to the new owner, Dex Holdings, and therefore it would be possible for that firm to be required to divulge financial information for purposes of determining the support provided by QCI to Qwest.[84]

DoD/FEA might support several of these proposals if they were feasible, and if they would not impair the resolution of this case. However, Qwest has made quite clear that these conditions are unacceptable from its standpoint.[85] Staff is apparently banking on the possibility that QCI is sufficiently desperate to consummate this sale that it will accept virtually any conditions the Commission might impose. This is a risky gamble. Even if Qwest were to accept the conditions for now, that action adds the risk that events

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[82] *See* page 8, *supra*.
[83] In addition, Dr. Selwyn stated during examination by Commissioner Hemstad that, because in his view the Agreement was not specific, a Commission order approving the Agreement should require that the up-front payment come from QCI, not Qwest, thereby simply ensuring that the money comes from the proceeds of the sale. Transcript, p. 996.
[84] Exhibit 370, pp. 28-9.
[85] *See*, *e.g.*, Exhibit 94, p. 4.

not now foreseen might allow a court or the Commission to later find them to be confiscatory. Furthermore, similar conditions, as appropriate, could still be addressed independently by the Commission in a subsequent proceeding should the need arise. The advantages from such a process are two fold—a more thoughtful, focused inquiry, and the avoidance of any unsettling impact upon the Agreement's appropriate, fair and beneficial resolution of all the issues in this proceeding.

Staff's legal argument, unnecessary and premature at this point, that Dex Holdings, although unaffiliated with Qwest, can still be treated as an "affiliated interest" and be required to divulge financial information to determine the amount of support to be provided by QCI to Qwest is certain to be challenged in court. Such challenges could derail not only this particular provision, but also the implementation of the entire order, thereby threatening the significant ratepayer benefits that the Commission, Staff, Public Counsel and intervening parties have expended so much effort to obtain.

For the foregoing reasons, DoD/FEA recommends that the Commission disregard the Staff's objections and approve the Agreement as being in the public interest and an appropriate, fair and beneficial resolution of all the issues in this proceeding.

CONCLUSION

DoD/FEA's interest in a prompt and fair resolution of this proceeding is driven by its interests as a large Qwest customer for a stabilized, financially strengthened QCI/Qwest and its desire that continued litigation not reduce its opportunity to share in the distribution of the Qwest Dex sale proceeds to which it is entitled under applicable

precedent. The settlement Agreement was an opportunity to eliminate certain risks inherent in the complex, novel and highly disputed litigation that exists in this proceeding. The Agreement represents a fair balancing of ratepayer and shareholder interests. Ratepayers gain an immediate significant refund in the form of a bill credit and significant ongoing rate reduction benefits for 15 years. A financially strengthened QCI/Qwest is a result. Accordingly, the Commission should either issue an order approving the Agreement and terminating the proceeding, or issue an order that incorporates the essential terms of the Agreement so that there is no further litigation.[86]

Respectfully Submitted,

Stephen S. Melnikoff
General Attorney

Regulatory Law Office
Office of the Judge Advocate General
U. S. Army Litigation Center
901 N. Stuart Street, Suite 700
Arlington, VA 22203-1837
(703) 696-1643

For

The United States Department of Defense

And

All Other Federal Executive Agencies

Dated: July 2, 2003

[86] The parties to the Agreement have committed not to challenge the terms of such an order. Any subsequent failure by Qwest to comply with any of those approved or incorporated terms would constitute a violation of the Commission's order and would allow the Commission to invoke its enforcement authority to ensure that all benefits promised to Washington ratepayers are realized.