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 QWEST'S OPENING BRIEF

NON-CONFIDENTIAL VERSION

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I. INTRODUCTION

1 In this proceeding, Qwest has filed an application asking the Commission to disclaim jurisdiction over this transaction, which is the transfer of the Dex business through an arm's length sale to a third party. In the alternative, Qwest asks the Commission to approve the transfer and enter an order disposing of the gain on the sale in the manner set forth in the Settlement Agreement ("Settlement Agreement") between Qwest, Public Counsel, AARP, WeBTEC and DOD.

2 In considering the issues presented, the Commission should consider the sale in the context of the financial needs of the business, the legal principles surrounding this issue and the public interest. Qwest submits that those considerations will lead the Commission to conclude that the sale is necessary for the company's financial health, is consistent with the law, and is in the public interest. Qwest does not believe that the Commission can or should find, as Staff suggests, that a bankruptcy filing by the Qwest parent company or any of its subsidiaries is in the public interest. Nor should it assume a phantom sale price that has no basis in the market, does not represent fair market value, and would defeat the purpose of the sale.

3 The sale of Dex is an essential component of Qwest's plan to delever its balance sheet and reduce debt. It is integral to Qwest's improved and improving financial condition, as the sale of Dex allowed Qwest to renegotiate covenants and other terms of a significant credit facility in September 2002, at a time when Qwest was facing the possibility that it would otherwise violate those loan covenants and be forced to file bankruptcy. The sale represents the sale of a non-core asset of the business that will enable Qwest to continue to improve its financial situation. The sale of Dex produced a fair market value price for the asset, and Qwest's financial need to sell the asset did not lower the price received.

4 The Commission and the Washington Supreme Court have acknowledged that Qwest has always been free to sell the publishing business. Qwest is doing so now because the business

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consisting of directory publishing and yellow pages advertising is not part of the company's core business and because the sale was a necessary component of the Second Amended and Restated Credit Agreement ("ARCA"). Without the ARCA, bankruptcy seemed likely in August 2002. Even Qwest's recently improved financial situation is built on the assumption that the sale will close. Staff's primary recommendation in this case, that the Commission deny the sale, is wholly inconsistent with the public interest. Staff's recommendation increases the threat of bankruptcy. Staff's recommendation could put Washington in a "go it alone" situation with regard to directory publication, and, even if it were possible to "carve Washington out," such a result would produce significantly less benefit for Washington ratepayers than the Settlement Agreement does.

5 It is clear that Staff would like to see imputation grow and stay in place forever. However, it is even more clear that such a result is impossible. Twelve of Qwest's fourteen states have approved or will take no action on the Dex sale. The sale transaction is closed as to seven of those states, and that part of the business is no longer owned by Qwest. The *status quo* prior to the sale transaction has been changed. Qwest will no longer operate a consolidated 14-state publishing operation. The historic imputation in Washington was an interim solution to an affiliate transaction in which the Commission found that the regulated utility had received an unacceptable level of compensation. It was never intended to be perpetual. Both the Commission and the Supreme Court have recognized that imputation may end on the sale of the business, after an appropriate disposition of the gain.

6 The sale, with the conditions agreed to by the settling parties, including a $67 million up front bill credit and revenue credits for 15 years to amortize the remaining portion of the gain, is in the public interest. The settlement offers a final resolution to the Dex issue and fairly and appropriately balances ratepayer and shareholder interests over an extended period.

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II. JURISDICTION

7 The parties to this case are Qwest Corporation ("QC"), on behalf of itself and on behalf of its parent company, Qwest Services Corporation ("QSC"), and its ultimate parent, Qwest Communications International Inc. ("QCI"), (referred to by some as QCII and collectively sometimes referred to as "Qwest"); Dex Holdings LLC ("Dex Holdings"); Public Counsel ("Public Counsel"); the Washington Electronic Business and Telecommunications Coalition ("WeBTEC"); the Department of Defense (DOD); AARP ("AARP"); XO Washington ("XO"); and Commission Staff ("Staff"). The current directory publisher for QC in Washington is Qwest Dex, Inc. ("Qwest Dex"), an affiliate of QC and subsidiary of QSC. The nature of the transaction underlying this application is more fully described in the application itself, as filed with the Commission on August 30, 2002.

8 The application asks the Commission to disclaim jurisdiction over the transfer of the publishing business to Dex Holdings. In this section of the brief, Qwest will review the history of Dex in Washington and the jurisdictional issues and arguments.

A. <u>The Commission Does Not Have Jurisdiction to Approve or Reject the Sale</u>

9 At issue is the Commission's role with respect to review and approval of the sale. In QC's view, the Commission has some—albeit limited—authority with respect to reviewing the terms of the sale. Specifically, for ratemaking purposes, the Commission may adopt appropriate ratemaking adjustments to reflect the sale in setting QC's rates. However, this authority over the transaction for ratemaking purposes does *not* give the Commission the power to approve or reject the sale, or to impose conditions in connection with its review of the sale. Previous decisions of the Commission and of the Washington Supreme Court have clearly distinguished between the Commission's authority to approve or reject a transaction versus the Commission's authority to adopt a particular ratemaking treatment for a transaction. Consistent with this previously recognized distinction, the Commission retains its authority

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with respect to appropriate ratemaking treatment of the sale. Amortization of the gain through revenue credits, which operate like imputation, recognizes and implements this ratemaking authority. As described below, however, the applicable Washington statutes do *not* give the Commission the authority to approve or reject the sale. In its order in this proceeding, the Commission should confirm that it does not have jurisdiction over the sale of the directory business.[1]

1. Previous Decisions of the Commission and of the Washington Supreme Court Regarding Directory Publishing Distinguish Between Approval of a Transaction Versus Ratemaking Treatment of a Transaction

10 Incident to the divestiture of the Bell System, Pacific Northwest Bell ("PNB") (the predecessor to QC and U S WEST Communications ("U S WEST")) transferred its directory publishing operations, including employees, tangible assets and working capital, to its unregulated affiliate, Landmark Publishing Company ("Landmark"). *Ex. 61, at 14-15*. In December 1983, PNB applied for approval of the transfers of the tangible assets, a leasehold interest, cash working capital and of publishing agreements between Landmark and PNB. The Commission approved the transfers and publishing agreements pursuant to Chapters 80.12 and 80.16 RCW. The Commission did not, however, approve the compensation associated with the transfers or publishing agreements for ratemaking purposes. Rather, the Commission reserved the right to determine reasonable revenues and expenses, together with their proper regulatory treatment, in any formal proceeding before the Commission dealing with the results of PNB's operations for ratemaking purposes.[2]

11 In Docket No. UT-950200, U S WEST challenged the Commission's authority to impute

[1] Qwest notes that, while Qwest believes the Commission lacks jurisdiction, Qwest has agreed in the Settlement Agreement (*Ex. 2*) not to contest the Commission's jurisdiction to approve the Settlement Agreement if no further conditions are imposed. Qwest reserves its jurisdictional arguments in the event the Commission rejects or attempts to modify the Settlement Agreement and/or attempts to add additional conditions on the sale.

2 *In re PNB Tel. Co., Cause No. FR-83-159*, Order Granting Application, in Part, (December 30, 1983), at 2; *In re the Petition of U S WEST Communications for an Accounting Order*, Docket No. UT-980948, Fourteenth Supplemental Order (the "*Accounting Order*"), ¶ 27.

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directory earnings to U S WEST's regulated operations. The Commission rejected this challenge and ordered imputation of directory earnings in an amount equal to what would have been shown on U S WEST's regulated accounts if the 1983 transfer had not occurred. The Commission ordered this as compensation for PNB's transfer of the "valuable regulatory asset" of the directory publishing business for inadequate consideration. The Commission imputed directory revenue of $80 million annually into U S WEST's regulated accounts in the rate case.[3]

12 On appeal, the Washington Supreme Court upheld the Commission's decision in Docket No. UT-950200, but held that imputation of directory earnings could end when there was a sale of the business and fair compensation had been received by U S WEST.[4] In its decision, the Washington Supreme Court recognized the distinction between the Commission's authority with respect to approval of a transaction and the ratemaking treatment to be accorded to such a transaction:

> [T]he Commission did not 'unconditionally' approve the transfer of the publishing business. It *conditionally approved the transfer*, retaining jurisdiction as allowed by statute to set a fair compensation *in the next rate case*.[5]

According to the court, "the Commission has the statutory authority under RCW 80.36 to impute income to US West for rate-setting purposes."[6] The court also recognized the Commission's statutory authority under the affiliated interests statutes to impute revenue in calculating U S WEST's revenue requirement, citing RCW 80.16.050 ("imputation of revenue is included in the power to revise and amend the contract between the two affiliates") and RCW 80.16.030 (which "authorizes the Commission to disallow unreasonable compensation to

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[3] *WUTC v. U S WEST Communications, Inc.,* Docket No. UT-950200, Fifteenth Supplemental Order. In addition, in Docket No. UT-970766, the Company's rates were adjusted based on updated earnings information. This case did not change the mechanism of imputation, but increased the annual revenue imputation from $80 million to $85 million.

[4] *U S WEST Communications, Inc. v. WUTC,* 134 Wash.2d 48, 102, 949 P.2d 1337 (1997).

[5] *134 Wash.2d at 98* (emphasis added).

[6] *Id. at 95*.

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an affiliated company *for purposes of ratemaking*").[7]

13 Following the Supreme Court decision, U S WEST filed a request to end imputation in Docket No. UT-980948. U S WEST introduced evidence of the value of the directory business as it had existed in 1983 and evidence that the cumulative publishing fees received by PNB and imputed directory earnings included in rates of PNB and U S WEST since divestiture exceeded that value plus reasonable interest since 1983. *Ex. 61, at 16*. The Commission denied U S WEST's request, finding that "the Yellow Pages publishing activity has not been transferred permanently to USWC's affiliate *for regulatory purposes*."[8] The Commission held that it had only been asked in 1983 and later cases to approve certain publishing agreements and transfers of certain tangible assets and cash.[9] The Commission stated that it "will continue to regulate USWC as though it retains all rights to the asset."[10] This regulation includes a continuation of imputation, which the Commission described as "a mechanism by which USWC's operating results are restated to reflect earnings as if the Yellow Pages directory business were retained within the company's Washington operations."[11]

14 QC does not challenge the Commission's *ratemaking* authority with respect to the terms of the transaction. In fact, the revenue credits proposed in the Settlement Agreement effectively continue the ratemaking treatment previously adopted by the Commission. This ratemaking authority is the extent of the Commission's jurisdiction over the transaction, however. The Commission does not have jurisdiction to approve or deny the sale, or to impose conditions in connection with the sale.

2. The Dex Sale Does Not Require Commission Approval

15 RCW 80.12.020 requires Commission approval of any sale, lease, assignment or other disposal

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[7] *Id. at 92-93* (emphasis added).

[8] *Accounting Order*, ¶ 19.

[9] *Id.,* ¶¶ 169, 176, 177.

[10] *Id.,* ¶ 169.

[11] *Id.,* ¶ 80.

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by a public service company of any of its franchises, properties or facilities *which are necessary or useful in the performance of its duties to the public*. The Commission's rules clarify that, for purposes of RCW 80.12.020, property is not "necessary or useful" if it is excluded from the public service company's rate base, by order or otherwise. *WAC 480-143-180(4).*

16 PNB published directories for PNB's exchanges in Washington. Before divestiture in 1984, PNB's regulated accounts included both the expenses and the revenues associated with its directory business operations. The business assets associated with the directory publishing business comprise (1) the tangible asset investment associated with directory publishing included in PNB's regulated rate base, which was the subject of the 1983 application and thereafter was removed from rate base, and (2) the goodwill associated with the directory advertising business and the right to publish a directory on behalf of U S WEST, which are items never included in the rate base of QC or its predecessors. Accordingly, while the Commission retains its ratemaking authority to reflect the impact of the sale in setting rates, the sale itself does not require Commission approval.

a) Assets previously included in rate base were transferred in 1983, with the Commission's approval.

17 As described above, the 1983 application submitted by PNB related to the assets then included in rate base relating to the directory publishing business. These assets included tangible assets (station equipment, office equipment and furniture), a leasehold interest, and cash working capital worth $13.7 million. *Ex. 61, at 15.*[12] While the Commission found that this transfer was "not a completed transfer of the entire publishing business," it appears undisputed that as to these specific assets, a transfer was effected.[13] Following approval of this transfer in 1984,

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[12] *Accounting Order*, ¶¶ *24-25, 167.*

[13] *Id.* ¶¶ *154, 167.* The *Accounting Order* repeatedly states that PNB had transferred certain assets, but only temporarily outsourced the publishing function. *Id.,* at ¶¶ 141, 147, 155, 158, 159, 176. This statement, combined with the many references in the Accounting Order that PNB had not permanently transferred the "entire" business or the "publishing function" (*see, id. Synopsis,* ¶¶ 19, 141, 153, 154), suggests that the Commission held that the tangible and certain intangible directory assets were permanently transferred to PNB's unregulated affiliate (now Qwest Dex), but not all rights to the asset had been addressed by the Commission. *Id.* at ¶ 169.

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none of the assets associated with the directory publishing business was included in the rate base of PNB or its successors. *Ex. 101, at 22*. Thus, as to these assets already transferred, no Commission approval is necessary for the transfer to occur as a part of the Dex sale.

b) <u>Goodwill and other intangible assets have never been included in the rate base of QC or its predecessors.</u>

18 As to the remaining business assets, PNB's regulated rate base did not include any amount for the intangible assets of going concern value of the directory business, the right to publish directories for the telephone company or any other form of unrealized goodwill (collectively hereinafter, "goodwill"). In 1916, the Commission established a principle that it follows to this day: Goodwill, whether realized or unrealized, is excluded from rate base. *Ex. 101, at 17*. It is a fundamental principle of utility ratemaking that goodwill, or intangible assets of the type being transferred here, are not includable in rate base.[14] As Charles Phillips explains:

> To include good will in the rate base would involve circular reasoning: its value depends on a utility's earnings which, in turn, depend on the rates established by the commission. Its inclusion, therefore, would permit the capitalization of expected future earnings. Good will has not been accepted for purposes of ratemaking.

CHARLES F. PHILLIPS, JR., The Regulation of Public Utilities 351 (3d ed. 1993) (citations omitted). Indeed, the Washington Commission has rejected attempts by utilities to include goodwill and similar intangible assets in rate base.[15]

19 Moreover, Washington ratepayers have never borne the risk of capital loss on goodwill, including the goodwill of the directory advertising business. *Ex. 101, at 17*. The goodwill associated with the directory business in Washington has always been excluded from the rate

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[14] *See, e.g.*, *General Tel., etc. v. Iowa State Commerce Com'n*, 275 N.W.2d 364 (1979)(holding that rate base does not include things not reflected in book value, such as goodwill); *Re Southern California Edison Co.*, 90 PUR4th 45, 60 (Cal. P.U.C. 1988) ("The name and reputation of a utility is not an asset to which ratepayers have a claim. Indeed, the Commission has never included good will in the rate base of a utility for ratemaking purposes.").

[15] *WUTC v. Continental Telephone Co. of the Northwest, Inc.,* 14 P.U.R.4th 276, (Wash.U.T.C. 1976). The Commission's current accounting regulations for telecommunications companies reflects this exclusion of goodwill. According to WAC 480-120-031(3)(i), acquired property is recorded at net book value rather than acquisition cost, unless the Commission approves a different accounting treatment.

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base of PNB, U S WEST and QC. In fact, there is no asset of any kind on QC's Washington regulated asset accounts which pertains to the directory business. Therefore, the assets being transferred here are those that have not been included in rate base, which in turn means they are not "necessary or useful," and, therefore, are not subject to the Commission's jurisdiction under RCW 80.12.020. Accordingly, the transfer of goodwill to the Buyer does not require approval, even if the transferor is QC.

B. <u>Even if Commission Approval is Necessary, the Commission Lacks the Authority to Impose Conditions on Approval of the Transaction</u>

20 Even if the Commission has jurisdiction to approve or deny the sale of Dex, it lacks the authority to condition its approval on the Company's compliance with the conditions recommended by Staff. Unlike ratemaking actions, where the legislative grant of authority is fairly broad, the statutory delegation to commissions to review and approve the transfers of utility property is often quite narrow in purpose and scope. Washington is not an exception, and the Commission's unilateral imposition of conditions on the transfer of utility property would be *ultra vires*.

21 RCW 80.12.020 governs the transfer of property and requires an order from the Commission for any public service company to sell, lease, assign or otherwise dispose of the whole or any part of its franchises, properties or other facilities which are necessary or useful in the performance of its duties to the public. The Commission's rules provide that such transfers are subject to a "public interest" review. Specifically,

> [I]f, upon the examination of any application and accompanying exhibits, or upon a hearing concerning the same, the commission finds that the proposed transaction *is not consistent with the public interest*, it shall deny the application. WAC 480-143-170 (emphasis added).

That rule is consistent with RCW 80.01.040(3), which directs the Commission to "regulate in the public interest."

22 Neither the statutes nor the Commission's administrative rule describe the factors or analysis

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used to determine whether a transfer is "not consistent with the public interest." Rather, the Commission has expressed its preference to determine whether transfers are not consistent with the public interest on a case-by-case basis.[16] Nevertheless, the Commission's public interest review is not unlimited and its powers under statutes authorizing transfers of property are not absolute.[17] Specifically, both statutory and constitutional principles prohibit the Commission from imposing conditions on transfers of property under the guise of its "public interest" review.

1. The Applicable Statutes Do Not Give the Commission the Authority to Impose Conditions

23 The Washington Supreme Court has held that the Commission possesses only those powers granted by statute.[18] Where an agency exceeds its delegated authority, its actions are *ultra vires* and are void.[19] The statutes relevant to this proceeding--RCW 80.12.020 and RCW 80.01.040(3)--do not provide any express delegation of authority to the Commission to impose conditions on the transfer of property.

24 It is axiomatic that courts will not interpret statutes to insert that which the Legislature has omitted.[20] Indeed, where a statute is neither vague, nor ambiguous, nor irrational on its face, a court cannot insert words that the Legislature seemingly unintentionally omitted, or disregard words that were seemingly inadvertently included.[21] Here, there is nothing ambiguous or irrational about the statutes governing the transfer of property. Moreover, it is abundantly clear that such statues do not expressly provide that the Commission may condition such transfers.

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[16] *See In the matter relating to Transfer of Property,* Docket No. A-980084, General Order No. R-461 (1999) (rejecting suggestion that Commission set out public interest formula in rule).

[17] *See Diamond State Tel. Co. v. Pub. Serv. Comm'n ("Diamond State")*, 367 A.2d 644, 648 (1976) (so stating).

[18] *Cole v. WUTC,* 79 Wash.2d 302, 306, 485 P.2d 71 (1971) (concluding that the Commission "must be strictly limited in its operations to those powers granted by the legislature.").

[19] *See, e.g., Woolery v. Department of Social and Health Servs.,* 25 Wn.App. 762, 612 P.2d 1 (1980).

[20] *See Salts v. Estes,* 133 Wash.2d 160, 162, 943 P.2d 275 (1997) ("What the legislature has not seen fit to do . . . [the court will] decline to do by judicial proclamation in the guise of liberal construction.").

[21] *See, e.g., State ex rel. Hagan v. Chinook Hotel, Inc.*, 65 Wash.2d 573, 578-80, 399 P.2d 8 (1965) (so stating); *Vannoy v. Pacific Power & Light Co.,* 59 Wash.2d 623, 629, 369 P.2d 848 (1962) (same).

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25 If the Legislature had intended to allow the Commission to impose terms and conditions on the transfer of property, the Legislature would have expressly provided for it. Where state legislatures have intended to give their public utility commissions the authority to condition the approval of the transfer of property, they have done so expressly. For example, the property transfer statute in Hawaii provides that "[i]f the commission finds that *subject to such terms and conditions as it shall find to be just and reasonable* the proposed transaction will be consistent with the public interests, the commission shall enter an order approving and authorizing the transaction, upon the terms and conditions, and with the modifications." *HRS § 271-18 (Matthew-Bender 2002)* (emphasis added). Likewise, Colorado's public utility statutes provide that "[t]he assets of any public utility, . . . may be sold, assigned, or leased as any other property . . . but only upon authorization by the commission *and upon such terms and conditions as the commission may prescribe*." *CRS 40-5-105 (1993)* (emphasis added); *see also*, *IL ST CH 220 § 5/7-101 (3) (West 2002)* (under transfers of property among affiliates, "[t]he Commission may condition such approval in such manner as it may deem necessary to safeguard the public interest."). Similar wording is notably absent from the Washington Statute.

26 Neither do the statutes expressly give the Commission the authority to impose conditions on the transfer, nor do the statutes provide this authority implicitly. The Washington Courts have strictly interpreted the statutes that delegate authority to the Commission.[22] However, Washington law recognizes that in some instances, an agency may exercise power where it is "necessary" to implement a statutory scheme.[23] Nevertheless, the Washington Supreme Court has held that such "necessary" or implied authority cannot exist where the agency's action under such authority touches on constitutional limits.[24] As discussed in the next sections, the

[22] *Cole,* 79 Wash.2d at 306.

[23] *See In re Little,* 95 Wash.2d 545, 627 P.2d 543 (1981) (so stating), overruled on other grounds in *State v. Danforth,* 97 Wash.2d 255, 643 P.2d 882 (1982).

[24] *See Hillis Homes, Inc., v. Snohomish Cy.,* 97 Wash.2d 804, 808, 650 P.2d 193 (1982) (holding that without express authority, action by county which is considered suspect under the Washington State Constitution is invalid, no matter how necessary it might be).

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exercise of such implied authority would infringe upon constitutional rights.

2. Constitutional Principles Prohibit the Commission from Imposing Conditions on Transfers of Utility Property

27 Imposing conditions on the transfer of utility property reduces a utility's constitutional rights to contract and freely alienate its property.[25] Consequently, the power to impose conditions on the transfer of utility property cannot be necessarily implied in RCW 80.12.020. Although the Washington courts have not directly addressed the question, the Washington Supreme Court has already indicated a reluctance to read more into RCW 80.12.020 than what is expressly provided in the statute.[26] Indeed, other authorities have limited the reach of similar regulatory schemes.[27]

28 In order for the Commission to impose conditions on transfers of utility property, the Legislature must expressly provide such authority to the Commission. RCW 80.12.020 does not contain an express grant of such authority. Consequently, any imposition of conditions on the transfer of Dex would be *ultra vires*.

3. Washington Statute and Constitutional Principles Prohibit the Multi-State Financing Restrictions Suggested by Staff

29 Staff's recommendations seeking to impose interstate restrictions on QCI-QC financing and capital structure transactions extend beyond the Commission's statutory jurisdiction and violate constitutional principles.

30 The Commission derives its jurisdiction from the statute. The Legislature granted the

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[25] *See, e.g., Northern Pennsylvania Power Co. v. Pennsylvania Public Utility Commission,* 333 Pa. 265, 5 A.2d 133 (1939) (declaring, in context of the transfer of utility property, that "free alienation of property is an inherent right of the owner under our customs, law and constitutions") *overruled in part on other grounds in City of York v. Pennsylvania PUC,* 449 Pa. 136, 295 A.2d 825 (1972); 73B CJS, Public Utilities, § 72 (utility property transfer statutes "abridge to a certain extent the right to contract, [and] no application thereof not plainly warranted by the language uses should be made").

[26] *See US West Communications, Inc. v. WUTC,* 134 Wash.2d at 91 (not adopting argument that authority exists under RCW 80.12.020 to impute income for ratemaking purposes).

[27] *See, e.g., Pacific Power & Light Co. v. Federal Power Commission,* 111 F.2d 1014, 1016 (1940) (property transfer provisions under Federal Power Act narrowly construed); *Opinion of the Attorney General of Arizona,* Opinion No. 62-7, at 13 (1962) ("[the transfer statute] is a permissive statute passed for the protection of the public interest. The Corporation Commission *may only concern itself* with the questions relating to whether or not the proposed transfer will be injurious to the rights of the public."(Emphasis added.)).

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Commission the power and duty to 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." *RCW 80.01.040(3) (emphasis added).* Staff's recommendation that the Commission restrict and require pre-approval of certain broad categories of interstate, inter-company financing transactions is in direct conflict with the statutory limits of the Commission's authority.

31 Furthermore, Staff's proposed conditions violate the commerce clause of Article I, section 8, of the United States Constitution. The commerce clause grants Congress the power to regulate interstate commerce.[28] The courts have long recognized that the commerce clause correspondingly imposes limits on the powers of the states to regulate interstate commerce.[29] That principle, commonly referred to as the dormant or negative commerce clause, "grew out of the notion that the Constitution implicitly established a national free market" from which private trade would be free from state interference.[30] Although incidental burdens on interstate commerce are allowable where the state's interest is of legitimate local concern,[31] the state violates the commerce clause where "the burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefits."[32] Staff's proposed conditions violate the commerce clause because (1) they impose an undue burden on the Company's multi-state operations without furthering legitimate state interests, and (2) are excessive in light of the Commission's alternatives.

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[28] *FERC v. Mississippi*, 456 U.S. 742, 102 S.Ct. 2126 (1982).

[29] *South-Central Timber Development v. Wunnicke*, 467 U.S. 82, 104 S.Ct. 2237 (1984). The commerce clause restrictions are not limited to statues and rules. The commerce clause equally prohibits an agency's order or proceedings, which will impose undue burdens on interstate commerce. *See Middle South Energy, Inc., v. Arkansas Public Service Commission*, *772 F.2d 404 (1985)* (holding that commission's orders and proceedings violated commerce clause).

[30] *Wyoming v. Oklahoma*, 502 U.S. 437, 469, 112 S.Ct. 789 (1992); *Reeves, Inc. v. Stake*, 447 U.S. 429, 437, 100 S.Ct. 2271 (1980).

[31] *Philadelphia v. New Jersey*, 437 U.S. 617, 623-24, 98 S.Ct. 2531 (1978)

[32] *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142, 90 S.Ct. 844 (1970) (setting out the "undue burden" test); *see generally, General Motors Corp. v. Tracy*, 519 U.S. 278, n. 12, 117 S.Ct. 811 (1997) (affirming court's adoption and application of undue burden test).

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32 Qwest acknowledges that the Commission has a legitimate interest in ensuring that the transfer is not inconsistent with the public interest. However, Staff's proposed conditions are excessively burdensome in relation to that interest. As described by Mr. Cummings in his rebuttal testimony, Staff's proposed debt and equity restrictions impose onerous burdens on the Company's multi-state operations. *Ex. 178, at 19-21.* As a multi-state utility, the Company does not maintain Washington debt or Washington equity. *Id.* Just as the Company's revenues in other states support its Washington operations, a change in the equity or debt structure in Washington affects company-wide operations. To require the Company to seek pre-approval for those types of decisions would hamstring the Company's ability to operate its business, and as such, constitutes an undue burden. Indeed, courts have uniformly held that attempts by Commissions and state legislatures to require pre approval of equity and debt issuances for a multi-state company violate the commerce clause.[33]

33 In striking down a statute that gave a commission authority to pre-approve stock issuances on commerce clause grounds, the North Carolina Supreme Court explained:

> Any requirement for prior approval, by its very nature, contemplates that such approval may not be given. . . . [Where one action is allowed in one jurisdiction, but denied in another, the regulated entity] is stymied, for it is put in an impossible position. In our view, the mere possibility of such a conflict . . . makes [the commission's action] . . . an impermissible burden on interstate commerce[34]

The same rationale holds that Staff's other proposed conditions regarding the pre-approval of other capital structure transactions and contract terms unduly burden QC's flexibility and harm

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[33] See e.g., *Panhandle Eastern Pipe Line Co. v. Ohio Pub. Utilities Commission,* 56 Ohio St.2d 334, 383 N.E.2d 1163 (1978).

[34] *State Utilities Commission v. Southern Bell Telephone and Telegraph Co,* 288 N.C. 201, 217 S.E.2d 543 (1975). It should be noted that in *Southern Bell*, the North Carolina Supreme Court recognized that in addition to the commerce clause violation, by requiring pre approval of the company's actions in the area of debt and equity issuances "the inevitable consequence would be that the Commission would be required to inquire into and pass upon the needs of [the company] – matters which are clearly beyond the commission's lawful authority." *288 N.C. at 212* (citing *Utilities Comm. v. Telegraph Co.,* 22 N.C. App. 714, 721, 207 S.E.2d 771, 776 (1974)).

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customers in other states. Moreover, Staff fails to explain either what the perceived threat might be, or how those conditions "protect" Washington customers from that threat.

34 In addition to determining whether the state is imposing an undue burden in furtherance of a legitimate state interest, the courts also ask whether alternative means of achieving the purpose would impose fewer burdens on interstate commerce.[35] Here, the Commission already has a means of ensuring that the transfer is not inconsistent with the public interest – through its ratemaking treatment of the transaction. Consequently, the Commission does not need to impose Staff's conditions to fulfill its public interest obligations.

35 In sum, Staff's proposed conditions invite the Commission to engage in excessive regulatory behavior that would violate the scope of its authority under RCW 80.01.040 and the Washington public service laws and the commerce clause. It is noteworthy that even Staff admits that it does not know if the Commission has authority to impose the conditions it recommends. *Tr. 1401-1404.*

C. Assuming that the Commission has the Authority to Impose Conditions on Transfers of Utility Property, the Conditions Recommended by Staff are Unlawful, Arbitrary and Capricious

36 Even if the Commission has the legal authority to impose conditions on the sale of property, the conditions sought to be imposed must fall within the Commission's authority. The conditions recommended by Staff in this proceeding (1) fall outside the scope of conditions that the Commission could otherwise impose, and (2) would unlawfully usurp the Company's management prerogatives with regard to cash management, capital structure, and dividends. Consequently, imposition of the conditions recommended by Staff would be unlawful, arbitrary and capricious.

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[35] *See, e. g., Pike v. Bruce Church, Inc.,* 397 U.S. at 142.

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1. The Commission Must Have Independent Authority to Impose Conditions on the Transfer and such Conditions May Not Interfere with the Company's Management Prerogatives

37 As noted above, under some circumstances the Commission has the authority to deny the transfers of public service company property where the transfer is contrary to the public interest. *RCW 80.01.040(3); RCW 80.12.020; WAC 480-143-170.* However, when determining whether a transfer of utility property is "not consistent with the public interest" the Commission may not do indirectly that which it otherwise could not do directly.[36] Thus, to the extent the Commission has the authority to impose conditions on its approval of a transfer, the Commission may not impose conditions that the Commission would not ordinarily have the authority to impose independently.[37]

38 In addition, when imposing conditions upon utilities, the Commission must be mindful that management of the public service company belongs to the company.[38] The Commission is not a "super board of directors" for the Company.[39] Indeed, the U.S. Supreme Court has cautioned that "it must never be forgotten that while the state may regulate with a view to enforcing reasonable rates and charges, it is not the owner of the property of public utility companies, and it is not clothed with the general power of management incident to ownership."[40] Consequently, the Commission lacks the authority to impose conditions on the transfer of Dex that interfere with the Company's management prerogatives, and when the Commission's actions are in excess of statutory standards, its actions are unlawful, arbitrary and capricious**.** *RCW 34.05.570(3), (4)(c)*.

2. Staff's Conditions Lack Statutory Basis and, Moreover, Infringe Upon the

[36] *Diamond State Tel. Co. v. Pub. Serv. Comm'n,* 367 A.2d at 647.

[37] *See People ex rel. Iroquois Gas Corp. v. Public Service Commission,* 264 N.Y. 17, *189 N.E. 764 (1934)* (so holding). Where the Commission lacks ancillary authority to impose conditions on the transfer, the Commission's only option is to approve or disapprove the transfer based on the public interest.

[38] *See, e.g., Public Service Co v. Public Utilities Comm'n,* 653 P.2d 1117, 1123 (Colo. 1982).

[39] *Northern Pennsylvania Power Co.,* 333 Pa. at 267.

[40] *Southwestern Bell Tel. Co. v. Public Serv. Comm'n.*, 262 US 276, 289, 43 S.Ct. 544, 67 L.Ed. 981 (1923).

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Company's Management Prerogatives

39 In this proceeding, Staff suggests the Commission (if it will not deny the sale outright) impose four conditions (one with three subparts, for a total of six conditions) on the transfer of Dex. Those conditions fall within three broad categories: (1) conditions that pertain to contractual obligations between the parties, (2) conditions that pertain to the Company's capital structure, and (3) conditions that pertain to the Company's dividends. Each category and the respective conditions are discussed below.

a) <u>Conditions pertaining to contracts.</u>

40 Staff suggests the Commission adopt three conditions relating to the Company's contracts. First, Staff suggests the Commission require that QC and QCI enter into a contract in which QCI compensates QC each year in cash for the expected amount that QC could otherwise realize from the directory publishing function. *Ex. 370, at 23*. Second, Staff suggests that the Commission require that QCI provide Washington customers with a one-time payment to compensate them for the additional risks that QCI has created for customers of QC. *Id. at 24*. Finally, Staff requests that the Commission require the Company to obtain prior approval before making any changes to the publishing agreement and any other agreement involving the Company. *Id. at 26a*.

41 These proposed conditions must be considered against the backdrop of a fundamental principle: the Commission's authority is "strictly limited in its operations to those powers granted by the legislature."[41] Indeed, in "performing [its] duty it must be kept in mind that the commission does not have *jurisdiction over all contracts* of a public service company, or over its entire financial management."[42] Therefore, although "it is true that certain aspects of a utility's contracts are specifically regulated by the Public Utility Law, the act does not grant the PUC

[41] *State ex el. PUD 1 v. Department of Pub. Serv.,* 21 Wash.2d 201, 150 P.2d 709 (1944).

[42] *Blue Mountain Consol. Water Co. v. Pub. Serv. Comm'n,* 189 A. 545, 125 Pa. Super. 1, 8 (1937) (emphasis added).

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general supervisory power over contracts."[43] Rather, a commission must have express authority to modify the terms and conditions of existing contracts, and where such authority is given, the Commission must adhere to the statute providing the authority.[44]

42 The Washington Legislature has given the Commission neither the general supervisory authority over a utility's contracts, nor the authority to insert into a utility's contracts whatever terms and conditions the Commission thinks might be warranted. Although RCW 80.12.020 allows the Commission to investigate the terms and conditions in the contract for the transfer of utility property, it is for the limited purpose of determining whether *the transfer itself* is in the public interest. That statute does not give the Commission the authority to interfere with a utility's contracts in the manner Staff recommends.

43 Moreover, Staff's recommended conditions reach too far. Staff has not shown that the transfer is unconscionable, oppressive, or impairs the Company's public service obligation, nor can it make such a showing. The transfer is the product of an arms' length agreement, entered into in good faith by both parties. Consequently, Staff is intruding upon the Company's management prerogatives when it insists on inserting conditions that the parties did not agree to, and by attempting to impose obligations on the Company that simply are not warranted. The Commission should reject Staff's conditions.[45]

b) Conditions pertaining to capital structure.

44 Staff recommends the Commission adopt two conditions with respect to the Company's capital structure. First, Staff suggests that the Commission prohibit QC from increasing the debt-to-equity ratio above the October 2002 level of 48.32% without prior Commission authorization. *Ex. 370, at 24, 26a*. Second, Staff urges the Commission to prohibit QC from lending cash or

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[43] *Leveto v. National Fuel Gas Distribution Corp,* Pa. Super. 510, 366 A.2d 270 (1976).

[44] *US v. Utah Power and* Light Co., 98 Id. 665, 570 P.2d 1353 (1977) (commission's authority to unilaterally alter rate contract must be express; statute providing for unilateral modification required certain findings).

[45] It should be noted that while the Commission lacks the authority to compel QC to enter into a particular form of contract, as an exercise of its ratemaking authority under Chapter 80.36 RCW, the Commission may impute revenues to QC as if such a contract existed. *See US West Communications, Inc. v. WUTC*, 134 Wash.2d at 95.

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otherwise providing credit to QCI or any affiliate of QCI without prior Commission authorization. *Id*. Staff contends both conditions are necessary to "protect QC and its customers from the ongoing financial risks of QCII's other enterprises." *Id*.

45 Outside the ratemaking context, courts have prohibited commissions from requiring companies to maintain certain capital structures. For example, in *Diamond State,* the court rejected an attempt by the Delaware Commission to dictate certain debt-to-equity decisions.[46] The commission argued that its intrusion into the company's capital structure was justified because by managing the Company's issuance of debt vs. equity the Commission could forestall a subsequent rate increase.[47] The court rejected that argument, holding that "the commission may not seek to control rates indirectly by seeking to control the fiscal policies of a public utility."[48] Even when a commission is exercising its ratemaking authority, it cannot simply substitute a particular capital structure for the utility's actual capital structure.[49]

46 Although Staff may consider its proposed conditions to be necessary--much like the conditions imposed in *Diamond State*--that intention alone does not suffice to vest the Commission with the authority to impose those conditions. At bottom, the Commission may not overrule or condition the Company's core business judgments, such as how the Company will manage its debt-to-equity or its loan arrangements. Indeed, the existing affiliate interest statutes and requirements would already cover the loan arrangements contemplated in Staff's second condition, thus making the condition duplicative and unnecessary. Moreover, it should not be overlooked that like the property transfer statutes, the affiliate interest statutes do not provide that the Commission may impose conditions on the approval of an affiliated interest

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[46] 367 A.2d at 648.

[47] *Id*. at 646.

[48] *Id.* at 647 (*citing Application of Diamond State Tel. Co.,* 1 Storey 525, 149 A.2d 324 (1959)).

[49] *See South Central Bell Tel. Co. v. Louisiana Pub. Serv. Comm'n, 594* So.2d 357, 364-365 (Sup. Ct. LA 1992) ("*South Central*"). In *South Central*, the Louisiana PSC disregarded the telephone company's actual capital structure and instead used a hypothetical capital structure for ratemaking purposes without first determining that the actual structure was imprudent or unreasonable. *594 So.2d at 362*. The Louisiana Supreme Court reversed the Louisiana PSC and held that the commission acted arbitrarily, capriciously and unreasonably in its unexplained departure from the prudent investment rule.

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transaction. *See* RCW Chapter 80.16. Consequently, although the Legislature could have given the Commission authority to precondition such transactions, it has chosen not to. Therefore, the Commission should decline to impose Staff's suggested conditions on the transfer of Dex.

c) <u>Conditions pertaining to dividends.</u>

47 In addition to the conditions noted above, Staff proposes that the Commission prohibit the Company from increasing the dividend to QSC without prior Commission approval. *Ex. 370, at 24, 26a*. Again, Staff contends that the condition is necessary to "protect QC and its customers from the ongoing financial risks of QCII's other enterprises." The Commission has no authority to set conditions on dividends, however.

48 Absent express authority, commissions may not set conditions on dividends.[50] Corporate management must be able to retain its prerogative to design a dividend policy that is responsive to changes in circumstances. Without such management flexibility, corporations would be limited in their ability to raise capital, and would be unable to satisfy their obligations to shareholders.[51] Where commissions are allowed to interfere with a company's dividend policy, it has been under the express statutory authority and only for limited purposes.[52] If the Legislature had intended the Commission to have authority in this area, it would have made a specific grant of such authority. However, it has not done so, perhaps recognizing that like the other two categories of conditions--contracts and capital structure--dividends are a matter that should be left to the Company's business judgment and discretion. Therefore, the Commission should reject the Staff's condition regarding prior approval for dividends.

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[50] *See Utah Power & Light Co. v. Public Service Commission,* 107 Utah 155, 152 P.2d 542, (1944) (commission has no plenary authority to govern dividends).

[51] *See Federal Power Commission v. Hope Natural Gas Compan*y, 320 US 591, 605 (1942) (commissions must "enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed.").

[52] *See Ohio Central Telephone Corp. v. Public Utilities Commission of Ohio,* 189 NE 650, 127 Ohio St. 556 (1934) (commission has statutory authority to prohibit dividends only where payments will cause deterioration of properties and impairment of services).

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49 In summary, the Commission lacks an independent basis from which to impose the conditions Staff suggests, because those conditions are an unnecessary burdening of the Company's ability to manage its contracts, property, and affairs. Staff is asking the Commission to accomplish indirectly, through the transfer statute, that which the Commission lacks the authority to do directly. Therefore, the Commission should decline to impose the conditions that Staff requests.

III. QWEST HAS ALWAYS BEEN FREE TO SELL THE PUBLISHING BUSINESS

50 The sale transaction is entirely consistent with what the Supreme Court and the Commission have acknowledged when discussing the issues of imputation and the transfer of the directory publishing business – that the company has always been free to sell the publishing business. The Court and Commission have found that a sale of the directory advertising business can occur, and that the disposition of the proceeds of the sale will be addressed at that time. Specifically, in its decision affirming the Commission's order in the U S WEST rate case that challenged imputation, the Supreme Court held that "[t]he Company has not been ordered to stay in the directory publishing business. The record shows the Company has *always been free to sell the business* for a fair value."[53] The Court went on to hold that "U S WEST may petition the Commission for an end to imputation if and when it can show it has received fair value for the transfer of the asset."[54]

51 In the Commission order that was on appeal, the Commission stated that "*neither never-ending imputation* nor seizure of income *is contemplated* or attempted here. The profits of non-utility affiliates are not touched in any way. They are merely imputed to [U S WEST] as is permitted by law." The Commission in its ruling regarding the transfer of the publishing rights explained that if the transfer were treated as a sale of the asset and a fair price paid, then imputation of

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[53] *U S WEST v. WUTC,* 134 Wash. 2d at 98 (emphasis added).

[54] *Id.* at 102. The quoted passage speaks of imputation ending when "U S WEST" receives fair value. By virtue of the sale to Dex Holdings, the publishing agreement and the conditions agreed to in the Settlement Agreement, QC and QC's ratepayers are receiving fair value for the transfer of the asset.

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revenue would cease.[55]

52 Again, in the Accounting Order the Commission held that imputation was an interim mechanism related to the affiliate transaction between QC and Dex.[56] The Commission also noted that Qwest was free to ask for a change in imputation at any time, and that the Commission would make a decision on the facts presented as to whether to end imputation and distribute the gain.[57]

53 Consistent with all of these prior decisions, Qwest now seeks to sell the directory publishing business. As such, imputation should end, as set forth in Qwest's testimony and the Settlement Agreement. There has been no suggestion in any prior cases that the Commission could deny the sale transaction, or that the Commission could or would order Qwest to remain in the publishing business. Thus, the question is whether fair value was received in the Dex sale transaction. The evidence shows that it was.

IV. THE SALE REFLECTS THE FAIR MARKET VALUE OF DEX

54 The sale of the Dex business is an arm's length transaction with an unaffiliated purchaser. The sale process was conducted over a four month period of time and produced a significant number of bidders for the property. Until the very last day of the process, two potential purchasers remained, bidding against each other for the property. Qwest's financial need to sell the property, while well known, did not diminish the ultimate sale price.

A. The $7.05 Billion Sale Price Represents the Fair Market Value of Dex

55 The actual sales price in an open, competitive transaction is a better measure of the value of an asset than forecasts of fair market value ("FMV"). *Ex. 221C, at 10-19.* In economics, fair market value generally represents the price at which an asset would be sold in a competitive

[55] *Id.* at 101-102.

[56] *Accounting Order,* ¶¶ 172-173.

[57] *Id.* at ¶¶ 179-180.

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market in which many willing buyers and sellers meet.[58] Around this narrow definition, a rich and complex theory of procurement and auctions has evolved which examines the institutional arrangements -- generally an auction or its equivalent -- under which a seller can expect to receive the maximum price that any buyer would be willing to pay for the asset. Such a process occurred in this case, eliciting the maximum price for Dex. *Id. at 11-13.*

1. There Was a Full and Fair Bidding Process

56 The sale was the second-largest leveraged buyout in history. The process amounted to an auction among the set of all interested and qualified bidders. The investment bankers and Qwest publicized the sale among all potential buyers. Thirty-nine parties signed the required confidentiality agreements and received the descriptive information in April 2002. Some of the independent bidders formed consortia and independent first-round bids were received from eight groups. Preliminary bids were made, and five groups ultimately chose to continue. Management presentations were made to all five groups, and each group was encouraged to undertake due diligence. *Ex. 221C, at 11.*

57 Between April and July 2002, several events affected the on-going auction. These events included a downward revision to Dex's estimated 2002 EBITDA;[59] a change in the publication schedule of some its Yellow Pages books which resulted in changes in annual revenue and EBITDA; and a change in Dex's accounting methods from point of publication to deferral and amortization accounting. The net effect of these changes was to lower prices below the levels in the preliminary bids, which were generally expressed as multiples of estimated 2002 EBITDA. By July, two private equity groups remained: Welsh, Carson/Carlyle, and the Blackstone Group. After a careful analysis of the bids, QCI selected the Welsh, Carson/Carlyle bid for the entire asset with closing staged over two geographic regions. *Id. at 11-12.*

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[58] U.S. capital markets are a textbook example of such a market: there are many informed and independent buyers and sellers of assets.

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

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58 During the course of the auction, several bidders dropped out of the process. In at least one case it is known that the reason was because the price was higher than that bidder's willingness to pay. At the end of sale, the buyer was unable to raise the full purchase price from external debt and equity markets. As part of the transaction, QCI agreed to receive up to $300 million of notes from the buyer and up to $42 to $217 million of the buyer's equity under certain conditions. *Id. at 12.*

59 These facts alone show that Staff's claim that "the nominal $7.05 billion sale price falls well short of providing compensation equal to the full economic value (business enterprise value) of Dex" is both speculative and wrong. *Ex. 311, at 39.* If this claim were even remotely correct, the buyer would have had no difficulty financing the purchase of an asset at a price that is "well short" of the market price. *Ex. 221C, at 12-13.* The simple fact is that the market would have produced another source of financing for an undervalued asset – the fact that it did not supports the fair value of the sale price. *Ex. 178, at 15-16.* As Mr. Kennard explained, there are significant amounts of equity capital available for investments of this type. *Tr. 257-260.* Thus, the fact that financing was not available for a quality asset indicates that the price paid was near or at the top of the market. *Ex. 178, at 15-16.*

60 The sale generated the maximum revenue for Qwest. For corporate acquisitions, all bidders generally have access to the same information and are generally as equally risk-averse as the seller. Differences in valuations of the asset are unlikely to arise because of differences in valuation methods—these are standard among financial analysts—but can arise from differences in synergies with the buyer's own assets. Nonetheless, no bidder would permit the asset to be sold to another party at a price less than that bidder's own valuation; to do so would amount to turning away profits. The seller's valuation of the asset generally does not affect the sales price. Once the seller agrees to sell the asset, it is the valuation of the buyers that determines the sales price. *Ex. 221C, at 13-14.*

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2. The Realized Price Falls Well Within the Range of Values Established by Lehman Brothers and Merrill Lynch

61 The actual sale price is well within the ranges of fair market values estimated at the time of the sale. *Exs. 317C, 319C.* Analysts' valuations are estimates of the financial value of the asset to a buyer based on historic data and assumptions about the future. They are fundamentally forecasts of the price that would result from a properly-conducted sale. Public and private analysts' valuations are used by buyers and sellers as part of the due diligence process. Buyers use the information to guide their determination of the maximum price they would be willing to pay, and sellers use the information to decide whether to sell the asset and to assure stockholders that the sale is likely to be in their financial interest. *Ex. 221C, at 14.*

62 For corporate acquisitions, analysts generally provide a range of valuations as consistent with fair market value, where the ranges are based on alternative assumptions about future events. These ranges of valuations are generally more accurate forecasts of the price resulting from an auction because most qualified and interested bidders are aware of the sale and their valuations are reflected in the auction price. *Id. at 14-15.*

63 In this case, both Merrill Lynch and Lehman Brothers prepared valuation estimates in the form of ranges. As seen in Exhibits 317C and 319C, the ultimate sale price falls well within the range of valuations presented by both firms. In some individual valuation estimates, the price was just slightly below the low end of the range estimated. However, the fairness opinions from these firms, discussed below, validate that the realized sale price was fair compensation to Qwest for the sale of Dex.

a) <u>Staff's reliance on the midpoint of the ranges is misplaced.</u>

64 Staff, through Dr. Selwyn, claims that the Merrill Lynch and Lehman Brothers valuation estimate reflect a "consensus" by these analysts that the sale price was below the fair market value. *Tr. 859.* In order to make this claim, Staff relies on the premise that the midpoint of all -the ranges of estimates represents a single point estimate from which it can be concluded that

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the sale price is less than the business enterprise value of Dex. *Tr. 857-858.* However, Staff's reliance on this premise is flawed. First, Dr. Selwyn stated repeatedly that he had not been retained by Staff to present a single point estimate of the fair market value of the Dex business. *Tr. 820, 874, 890.* Second, there is absolutely no indication anywhere in any of the analysts' presentations or materials that supports the claim that the midpoint of the ranges should be given special weight or value. Thus, there is no evidence on this record that the midpoint of the ranges reflects fair market value or a single reliable point estimate of the business enterprise value. Indeed, an estimated range for the fair-market value of an enterprise is just that -- a range of estimated fair-market values. Thus, any realized sale price within the range is consistent with the analyst's estimate of fair market value. *Ex. 221C, at 15, 20-22.*

65 The significance of the midpoint depends on what generates the range. For example, if a range reflects different long-run growth rates for revenue or earnings, the mid-point of the range would reflect a middle-of-the-road view (with respect to growth) of the value of the firm. On the other hand, if the range reflects the effect of two inconsistent assumptions (e.g., including or excluding some portion of the asset), the mid-point of the range has no significance. *Id. at 15.*

66 The midpoint of ranges is not significant except as a descriptive statistic which cannot be taken as an unbiased measure of average fair market value in any statistical sense. The reason should be obvious. Suppose an analyst considers three basic scenarios for valuation consisting of (a) high revenue growth, (b) medium revenue growth, and (c) low revenue growth. An average of the mid-points of these three ranges is not a good measure of anything. If low revenue growth is by far the most likely scenario, then an unweighted average of the three mid-points would overestimate the likely value of the asset. *Id. at 15-16.*

67 The discussion above explains why mid-points of ranges and means of mid-points of different ranges are not necessarily valid estimates of anything. Staff discusses five sets of analysts' valuations. Each of these valuations, Dr. Selwyn claims, shows that the realized price was less than the fair market value. However, the actual data tell a different story. Two of the five sets

of valuations (by Lehman Brothers and Merrill Lynch) are dated August 19, 2002 and reflect the latest values of historical and estimated future data, particularly Dex's estimates of 2002 EBITDA which were falling over time. Staff's averaging of the mid-point of ranges of fair market values conceals the fact that the realized price fell within the fair market value range in 12 of the 16 scenarios. *Exs. 317C, 319C.* In contrast, Staff's estimate of value (discussed below) is *above* the range in 15 of the 16 scenarios. *Id.*

b) The analyst's fairness opinions support the realized sale price.

68 Both analysts prepared fairness opinions which were presented to the QCI Board of Directors in connection with the transaction. Both opinions support the sale price as being fair to Qwest. The Lehman Brothers opinion states that Lehman Brothers is of the opinion that that, ". . . from a financial point of view, the Aggregate Consideration to be received by the Company in the Proposed Transaction is fair to the Company." *Ex. 321C, at 4.* Similarly, the Merrill Lynch opinion states that "the Consideration to be received by the Company pursuant to the Transaction is fair from a financial point of view to the Company. . . ." *Ex. 322C, at 3.* No evidence to the contrary was presented in this case. Based on all of the evidence supporting the transaction as one which produced a fair market value price, the Commission should conclude that the transaction was one in which fair value is received for the Dex asset.

3. Staff's Presentation of the Lehman Brothers Analysis, When Done Correctly, Supports the Realized Sale Price

69 Staff has stated that it did not present a single point estimate of the fair market value or the business enterprise value of Dex. *Tr. 820, 874.* However, Dr. Selwyn did present a discounted cash flow analysis that purports to do just that. *Ex. 320C.* Dr. Selwyn suggests his calculation "should be of particular interest to the WUTC because it represents the value that Dex's management believed the Dex business to have just prior to the date when the sale transaction was agreed to." *Ex. 311, at 35.* However, a correct evaluation of this document shows that it

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supports the realized sale price. Dr. Selwyn's Exhibit No. 320C shows that the levels and growth rates for revenues and EBITDA were reported as "financial projections of Dex management for 2002-2006" in a Lehman Brothers Confidential Descriptive Memorandum dated April 2002. But Dr. Selwyn has agreed that the Lehman Brothers and Merrill Lynch valuations of August 19, 2002 are a *better* representation of the valuation of Dex at the time when the transaction was agreed to. *Ex. 311, at 26.* Those valuations contained revised and updated growth projections, different from the April 2002 numbers.

70 A recalculation of Dr. Selwyn's Exhibit 320C, using his method and all of his assumptions, but replacing his revenue and EBITDA levels and growth rates (from before April 2002) with those used in the August 19, 2002 investment bankers' Board presentations, produces an Enterprise Value of **confidential** ************* **confidential,** which is slightly smaller than the realized sales price of $7,050 million and significantly smaller than Dr. Selwyn's estimated Enterprise Value of **confidential** ************** **confidential.** *Ex. 223C.*

71 There is a second concern with Dr. Selwyn's conclusion based on his discounted cash flow ("DCF") calculation. The method he uses is essentially that used by Bear Stearns in a February 5, 2002 Presentation. *Ex. 320C.* For the years 2002-2006, it calculates unlevered free cash flow. In 2006, it calculates a terminal value equal to seven (7) times the 2006 value of EBITDA. The net present value of these cash flows is then taken to be the implied Enterprise Value of the asset. Critical to this calculation, of course, is the assumption that the terminal value of Dex's cash flows is equal to 7.0 times EBITDA. While that assumption has some support in valuations based on comparable transactions and transactions in other industries, it is no more (or less) reasonable to apply that assumption in 2002 than in 2006. Indeed, since the 2002 level of EBITDA is estimated far more precisely (in August 2002) than the 2006 level of EBITDA, one might think that applying the assumption in 2002 would be more accurate. In any case, when Enterprise Value is measured as 7.0 times estimated 2002 EBITDA, the resulting fair market values are **confidential** ************* **confidential** (using Dr. Selwyn's

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April 2002 estimate of 2002 EBITDA) or **confidential** ************* **confidential** (using the investment bankers' August 2002 estimates of 2002 EBITDA). *Ex. 223C.*

72 Thus, it is apparent that to the extent Staff *does* purport to calculate a fair market value estimate for Dex, that estimate, if done correctly, amply supports the realized sale price.

4. QCI's Need to Sell the Asset was Not a Price-Impacting Factor

73 While it was common knowledge that Qwest wanted to sell assets (including Dex) to reduce debt and to attempt to avoid bankruptcy, it does not follow from that knowledge that the sales process would produce a price below fair market value.

74 Staff has claimed that Qwest's financial circumstances created a "distress sale" type environment for the sale of Dex, thereby reducing the price Qwest received. *Ex. 311, at 6, 16, 17, 23, 39, 40, 52, 110.* This is incorrect for a number of reasons. A fire-sale is one in which it is known that an asset must be sold and sold by a particular point in time. In selling assets like houses or furniture, a forced quick sale reduces the expected price to the seller because not all interested parties are aware that the sale is taking place and do not participate. *Ex. 221C, at 16.*

75 That does not apply to the sale of corporate assets like Qwest Dex for at least two reasons. First, the range of valuations across the population of buyers is much narrower for purchasing corporate assets like Dex. Buyers are sophisticated, are provided with the same set of basic financial data, and use the same publicly-available tools for valuing the asset. Consumer preferences and tastes do not come into the calculation of willingness to pay. Second, all potential buyers are made aware of the impending sale of the asset, and selling the asset over a longer period of time would not be likely to induce higher-valuation buyers to enter the auction or to change the maximum valuation among the buyers. *Id. at 18.*

76 Additionally, two factors suggest that Qwest's financial pressures did not adversely affect the Dex sale price. First, in an auction, it is the buyer's valuation of the asset that determines the price, not the seller's. A bidder would not permit the asset to be sold to another party at any

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price below its valuation, even if it were known that Qwest were under pressure to sell. For this reason, the pressures on Qwest to sell did not have a depressing effect on the sales price. Second, the fact that Qwest was under external pressure to sell Dex reduces what economists call the "lemons" problem in selling an asset under conditions of asymmetric information. Qwest's "external pressure" tends to remove the speculation regarding why Qwest would sell such an asset, and allow the potential buyers to concentrate on more rational valuation criteria. *Id. at 19.*

77 Finally, the Commission has persuasive evidence directly from the buyer that indicates that the buyer felt intense pressure from a competing bidder up until the last day of the sale process and that Dex fetched top dollar. As Mr. Kennard explained, the bidding process was intensely competitive. *Tr. 269-271.* Both the winning bid by Carlyle/Welsh Carson and a competing bid by the other remaining bidder were submitted on August 19, 2002. *Ex. 17.* Carlyle/Welsh Carson increased its bid by $50 million on that day, to ensure that they were competitive, knowing that the bids would be taken to the Board of Directors for consideration. *Tr. 348.*

B. Staff's Phantom Value for the Dex Asset is Not Supported by the Facts or the Law Surrounding this Issue

78 Staff has challenged the sale price of $7.05 billion, claiming that the realized sale price for the Dex business is too low. To support this contention, Staff points to a number of factors that Staff believes indicate that the sale price was below fair market value. These factors include Qwest's financial situation at the time of the sale, which Staff claims resulted in a distressed or fire-sale price, as well as the opinions of the investment bankers, which Staff claims support a conclusion that the price was below fair market value. As addressed above, it is clear that Qwest's financial condition, while a motivating factor for the sale, did not lower the price. It is also clear that the investment bankers supported the sale price as fair, and that Staff has taken an arbitrary and self-serving view of the valuation estimates prepared by those bankers. Neither factor supports Staff's contention.

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79 Staff has in fact agreed that it is not proposing a fair market value estimate for Dex. For all of the analysis and criticism of the valuation estimates in Staff's testimony, Staff presents no evidence that the sale process was not fair or that another buyer would have paid more. Indeed, although Staff argues that the midpoint of the ranges of the valuations is a valid point of comparison to evaluate whether the sale price was fair, Staff does not even advocate that the mid-point is the value that should be used for purposes of this case.

80 Instead, Staff creates a phantom value for the Dex business, and advocates that that value be used to determine the Washington ratepayer benefit. Staff bases its recommendation on a different measure of the value of Dex. On the theory that the sale should in perpetuity hold ratepayers harmless, Staff calculates the annuity value of the imputation currently flowing from Dex Yellow Pages to regulated telecommunications services, subject to an annual growth rate consistent with "the financial projections of Dex management for 2002-2006" in a Lehman Brothers Confidential Descriptive Memorandum. Under Staff's assumptions, the net present value of the perpetual imputation stream is **confidential** ************* **confidential** for Washington. This is **confidential** ***************** **confidential** higher than the Washington portion of the realized sale price. Additionally, extrapolated to a region-wide number, the total amount is **confidential** ************************************** ************ **confidential** more than the price produced by this arm's length transaction.

1. Staff Does Not Present an Alternate Calculation of FMV or BEV of Dex

81 The fair market value of the Dex business is a critical component of this case. However, Staff does not purport to calculate the FMV or BEV for Dex. *Tr. 820.* Dr. Selwyn, Staff's witness on this issue, has no experience with valuing a business such as Dex, or any business at all. *Tr. 828.* He has never worked as an investment banker. *Tr. 821.* Staff was not involved in the bidding or auction process. Staff does not contend that the sale was unfair, and does not assert that another buyer would have paid more for the business. *Tr. 862-863.*

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82 Yet the question of whether fair value was received for the business is a central issue. As noted above, when fair value is received, imputation must end.[60] Staff attempts to obscure the question by calculating a fair value based on the assumption that Qwest is not free to sell Dex and that ratepayers are perpetually entitled to receive directory publishing profits through imputation. Staff offers no authority supporting its substitution of a perpetual ratepayer benefit for the concept of fair market value.

2. Staff's Calculation of Value is Improperly Based on the NPV of Current Imputation, Growing in Perpetuity, Not Fair Market Value

83 Rather than addressing the fair market value of the business as evidenced by the market transaction, Staff bases its recommendation on a different measure of the value of Dex. On the theory that the sale should hold ratepayers harmless, Staff calculates the annuity value of the imputation currently flowing from Dex Yellow Pages to regulated telecommunications services, based on three assumptions: (i) the imputation formula and rate of return regulation will remain in place, unchanged, forever; (ii) the imputation amount will grow at the long-term growth rate for EBITDA assumed by Lehman Brothers in August 2002; and (iii) the relevant discount rate is 10.0 percent. Under these assumptions, the net present value of the perpetual imputation stream is **confidential** ********** **confidential,** which, using Staff's factor for the Washington share of revenue or earnings to allocate the sales proceeds, amounts to an enterprise value of **confidential** *************** **confidential.** *Ex. 311, at 54.* It is this amount that Staff recommends be used as the fair market value of Dex for Washington ratemaking purposes. *Ex. 311, at 109-110.*

84 This calculation obviously makes no reference to financial estimates of the value of Dex or to the realized market price for Dex. There is no reason to think that buyers would be willing to pay this amount for Dex, and Staff does not contend that there was any buyer in the real world who was willing to pay more than $7.05 billion.

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[60] *U S WEST v. WUTC, 134 Wash.2d at 101.*

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85 Staff's own methods imply that this valuation exceeds a fair market price for Dex. If the mid-points of the valuation ranges is a relevant point of comparison, as Staff's testimony suggests, then the value of **confidential** ***************** **confidential** is literally billions of dollars off the mark. Staff's calculation is **confidential** **************** **confidential** above the average of the mid-points of the Lehman Brothers' valuations in Dr. Selwyn's Table 1 (*Ex. 311, at 28)* and **confidential** ****************** **confidential** than the average of the mid-points of the Merrill Lynch valuations. *Ex. 319C*.

86 Staff's calculation does not establish the fair value for Dex. The only thing it does show is that under certain assumptions, the net present value of a perpetual annuity equal to the current level of Yellow Pages imputation in Washington (adjusted for future growth) exceeds analysts' estimates of the market value of Dex and exceeds the actual, realized price at which Dex was sold. This simply implies that the current imputation formula represents more than the Washington share of the entirety of Dex's value.

87 The assumptions underlying the calculation are unsupported and unreasonable, and do not produce any sort of realistic value for the Dex operations. First, the calculation assumes that imputation will grow at the long-term growth rate of EBITDA. This is an arbitrary assumption, as there is no demonstrated linkage between Dex's EBITDA and the Washington imputation calculation. Even if there were, the assumption must fail. This assumption by Staff essentially takes projections and forecasts and turns them into a guaranteed revenue stream. This is highly inappropriate. *Tr. 813.* These forecasts and projections were never represented by Dex to be guarantees of particular results. *Ex. 6.* Second, the calculation requires that this growing stream of imputation will continue in perpetuity. While the growth assumption is merely arbitrary, the view that the Washington ratepayer has an entitlement to a permanent flow of imputation from Yellow Pages has no support in law or Commission policy.

88 Staff claims that ratepayers are entitled to receive the entire fair market value of the asset (as Staff calculates it) and that the circumstances surrounding the sale of Dex caused the sales

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

89 Staff's calculation of value is based on the net present value (NPV) of current imputation, *growing in perpetuity*. Nothing in law or policy has granted the Washington ratepayer the claim in perpetuity on which Dr. Selwyn bases his calculation. As discussed in Section III above, both the Supreme Court and the Commission have said that perpetual imputation is not contemplated. Staff's calculation of a growing, never-ending imputation subverts the idea that Qwest can sell the asset by imposing a liability on Qwest for the sale that is far in excess of the sale price. It is inconceivable that imputation would remain in place, growing at a constant rate forever. Upon a sale, imputation must end, not continue forever.

3. Staff's Calculation of a Washington/Region-Wide Value is Not Supported by Any of the Financial Experts, and Does Not Reflect Fair Market Value

90 Staff has offered no support for its proposed valuation. Staff does not claim that the **confidential** ** **confidential** represent the fair market value of the business. *Tr. 860.* Staff does not claim that another buyer was willing to or actually did offer to purchase Dex for more than the realized sale price of $7.05 billion. *Tr. 862-863.* Staff's valuation is not supported by any investment banker or business valuation expert. Indeed, Staff's valuation falls *above* the range of estimates of the BEV of Dex for 15 of the 16 estimates prepared by Lehman Brothers and Merrill Lynch. *Exs. 317C, 319C.* Staff's valuation is not grounded in reality, and it flies in the face of the prior orders on this issue, which clearly state that imputation is not to continue forever.

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V. CALCULATING/ALLOCATING THE GAIN ON SALE

91 In this section of the brief, Qwest will discuss the framework for determining the proper disposition of the gain on the sale for ratemaking purposes. The discussion will explain how the gain on the sale should be calculated and how to analyze whether the gain should be allocated or shared between shareholders and ratepayers. The analysis will show that Staff's theory that ratepayers are entitled to 100% of the gain is flawed. It is based on the circular reasoning that ratepayers are entitled to 100% of the gain because they have always received the benefit of imputation. That reasoning cannot support a 100% allocation to ratepayers, as it ignores applicable case law. It also fails to take into account the fact that the Dex business is not a QC asset, and that the publishing agreement and non-compete agreement to which QC is a party do not represent 100% of the value of the transaction.

92 Qwest's analysis shows that the full gain on the sale for the Washington operations is **confidential** ********************** **confidential** as Staff postulates. This discussion will also show that the maximum amount that could be attributed to Washington ratepayers is **confidential** ******************************* **confidential**, after making appropriate adjustments to correctly determine the amount of the Washington gain that may be attributable to the regulatory publishing obligation for QC. *Ex. 133C.* Finally, this discussion will show that other calculations of value, such as the liquidated damages clause of the non-compete agreement, establish the Washington value for Dex at far less than the amount reflected in the Settlement Agreement.

A. <u>The Gain Calculation</u>

93 The calculation of the estimated gain on the Dex sale is straightforward. As in any gain calculation, the book value of the assets, and the costs of the sale are subtracted from the sale price. In this case, the book value of the assets is subtracted from the $7.05 billion sale price. After subtracting the estimated costs of the sale, the total gain is **confidential** ***********.

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confidential. *Ex. 134C.* However, this clearly does not end the inquiry.

94 The only value the Commission can (arguably) address for ratemaking purposes is value associated with the "regulatory asset" in Washington. The entire gain attributable to Washington is not at issue because the entire value of the business is not attributable to assets or benefits that QC is conferring. As shown in the testimony of Mr. Kennard, Mr. Burnett, and Ms. Koehler-Christensen, much of the value of Dex is attributable to its employees (*Tr. 304-305, 325-326, 449*), to its proprietary databases and customer relationships (*Tr. 513-514*), and to its entry into lines of business that are separate from the value associated with being the official directory publisher for QC. *Ex. 131, at 13-22, 39-45.* Thus, it is necessary to next determine what amount of the gain may be said to be attributed to the regulatory asset. To do this, several allocations must be performed.

B. <u>The Value Associated with Imputation is the Value that Dex receives in Connection with Fulfilling QC's Regulatory Publishing Obligations</u>

95 The historic imputation calculation was intended by the Commission to compensate ratepayers for the value that the Commission believed Qwest conferred on Dex by virtue of having Dex fulfill its regulatory publishing operations.[61] Thus, it is appropriate to look to the imputation formula to determine the amount of the gain that could arguably be considered to be derived from the "regulatory asset" due to the association with the regulatory publishing operation. It is clear that in the transaction at issue in this case, the publishing agreement and the non-compete agreement between QC and Dex Holdings constitute the entirety of that value. However, Qwest has defined the regulatory asset even more broadly than that, to the benefit of the ratepayers. Rather than simply valuing the publishing agreement and non-compete agreement, Qwest has undertaken to analyze the entire value of the Dex business, and to remove only the portion of the gain that is clearly not associated with the historic publishing obligations.

96 This analysis is supported by the Commission's Fourth Supplemental Order in Docket Nos. U-

[61] *Accounting Order, ¶ 172.*

89-2698-F and U-89-3245-P, dated January 16, 1990. There, the Commission accepted a Settlement Agreement ("1989 Settlement Agreement") between the parties containing an imputation calculation and established the basis for the imputation calculation that has been used ever since. Paragraph 18.H.a of the 1989 Settlement Agreement, which is attached to the Fourth Supplemental Order, states the starting point for the imputation calculation as follows: "U S WEST Direct's actual adjusted operating revenue *associated with the publication of telephone directories for U S WEST Communications* will be calculated [as follows]" (emphasis added). Thus, it is clear that only those revenues associated with publishing directories for QC should be available for the benefit of ratepayers and consequently that is the maximum amount of the sale transaction that can be considered for possible distribution to ratepayers.[62] The Commission affirmed the imputation formula in the Accounting Order.

97 The standard used for calculating directory imputation is also the appropriate standard for determining the Washington portion of the Dex gain that should be considered in this case. The settlement language indicates that it is only those revenues associated with *fulfilling the publishing operations of U S WEST* that the Commission considered to be available for the benefit of ratepayers. Only that portion has any nexus to the ratepayer or to the relationship between directory and local exchange service. *Ex. 131, at 8.*

98 There are four adjustments that need to be made in order to remove portions of the business that are not connected to Qwest's regulatory directory obligations. These adjustments remove the portions of the sale related to LCI, NewVentures, Secondary directories, and non-Qwest listings. Indeed, it is very likely that the only value that *can* be attributed to the right to publish QC's directories is the value associated with the publishing agreement and the non-compete agreement. As demonstrated by the testimony at the hearing, this value was not quantified by Staff, but in any event is no more than the liquidated damages for breach of those provisions, or

[62] This is true even under Staff's circular reasoning, which essentially states that Dex is a regulatory asset because revenues have always been imputed. As noted, this reasoning does not hold. However, if it did hold, the correct calculation of imputation would still limit the amount of the gain to less than 100% of the business.

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30% of the purchase price. Allocating that amount for Washington produces a value of approximately $369 million ($7.05 billion x 30% x 17.44%). This is of course far less than the amount that Qwest is willing to return to ratepayers under the Settlement Agreement.

1. LCI

99 LCI is an entity that was a part of the Qwest business prior to its merger with U S WEST. This business was not related to the publishing business when the publishing business was a part of the Company's regulated operations, nor has it been a part of the Dex publishing operations since the Qwest merger. At this time there is no gain identified with the LCI portion of this sale. However, there are assets associated with this entity. The value of the assets needs to be removed from the sale. LCI is not a part of the "regulatory asset" at issue, and all parties have accepted this adjustment. *Ex. 131, at 13-14.*

2. NewVentures

100 The NewVentures/Internet lines of business began as a separate company, Marketing Resources Company ("MRC") that was created in 1985, after divestiture and after the Commission approved the transfer of the tangible assets of the publishing business. MRC was created as a separate company and was not part of U S WEST Direct (Dex's predecessor). It was not until 1991 that NewVentures and U S WEST Direct became separate operating divisions of Marketing Resources Group, Inc. ("MRG"). MRG was formerly Landmark Publishing and in 1997 became U S WEST Dex. Inc. The two operations did not become integrated until after the July 2000 merger with Qwest. *Id. at 14.*

101 The NewVentures lines of business encompass the highest risk areas of direct marketing and internet. They have *never* been included in the Dex financial results provided to this Commission. Accordingly, the imputation calculation has not included those results. *Id.* With no real justification, Staff has rejected the adjustment to exclude this portion of the business. Staff's argument seems to focus on a statement in Qwest's 2000 affiliated interest disclosure

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statement suggesting that the financial results of the NewVentures business could not be separated. *Ex. 311, at 104.* The disclosure stated that the NewVentures and Internet lines of business were no longer conducted in a company or operating division separate from Dex Directories and that Qwest had not yet ascertained separate financials.

102 However, Staff is well aware that separate financial information is now available and was provided to Staff by Qwest in response to Public Counsel's Data Request ATG01-02S1. Further information was provided in confidential attachments to Public Counsel's Data Request ATG01-016S2 in this docket. While it was true that there were not separate financials available at the time the 2000 Affiliated Interest Report was filed, it is not true at this time as evidenced by the Company's responses to the data requests cited above. *Ex. 131, at 15.* Thus, there is no basis for Dr. Selwyn's allegation that the operations are integrated so as to justify inclusion of this portion of the sale in any Washington gain calculation.

3. Secondary Directories

103 Dex publishes both Primary directories and Secondary directories. Primary directories are the directories Dex publishes to cover the service areas for which QC is required to provide listings to its customers free of charge. Secondary directories include all other directories published by Dex, including regional and specialized directories and directories Dex publishes outside QC's local service area. *Id. at 15-16.*

104 Dex started publishing Secondary directories *after* the directory operations were transferred to the separate unregulated subsidiary. There is no history of Secondary directories being published while the directory operations were part of the regulated operations of any of QC's predecessors in Washington. Dex's Secondary directory business did not exist in 1984 and, therefore, was not part of the directory business transferred in 1984. Nor were revenues from Secondary directories included in the formula established in the 1989 Settlement Agreement. *Id. at 16.*

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105 Dex publishes two Secondary directories in Washington. The Greater Snohomish County directory is a directory published outside QC's service area which competes head-to-head with the directory published by Verizon, the local exchange carrier in Snohomish County. This directory, which was first published by Dex in December 1994, has nothing to do with QC or QC ratepayers. The scope of this directory is outside QC's service area. It is not published for QC and its customers. It is not targeted to QC customers, and it is not delivered to QC customers. The Greater Puget Sound On-the-Go directory is a specialized directory that includes only yellow pages and is targeted for use in automobiles and by wireless telephone users. The Greater Puget Sound directory was first published in 1998. Not only were secondary directories not a part of the pre-1984 directory business, they also do not, for the most part, facilitate the use of QC's telephone service. *Id. at 16-17.*

106 Secondary directories were not published in all the years that the directory operations were part of the regulated Pacific Northwest Bell operations. Secondary directories are not targeted to QC customers. Secondary directories are not tied to QC's regulatory obligation to provide Primary directories. These directories do not qualify as part of the regulatory directory obligation under the standard by which the imputation is determined, i.e., "the publication of telephone directories *for* U S WEST Communications" (now QC). Because they are not part of the regulatory obligation, Secondary directories should not be part of the relevant gain calculation. Also, Secondary directories do not facilitate the use of QC's telephone service. Therefore, that portion of the gain from the Dex sale attributable to these Secondary directories is not appropriately considered for sharing with QC customers. *Id. at 17-18.*

4. Non-Qwest Listings

107 Finally, non-Qwest listings are appropriately excluded from the gain calculation. Non-Qwest listings are those listings in the white pages of non-Qwest customers. Qwest has allocated a portion of the gain to value associated with the publication of those listings – that value is not

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attributable in any way to the historic directory publishing operations. Dex has expanded its directory business to meet the publishing needs of not only QC, but also many other local exchange carriers in the area. More than 25 percent of the listings Dex publishes in its Primary directories are not QC listings, but rather listings of Washington residences and businesses that purchase their telephone service from other local exchange carriers. Revenues earned from Dex's advertising to customers of other local exchange companies are not connected to QC's regulatory directory obligations in which QC customers may have an interest. *Id. at 19.*

108 Historically, PNB did publish a number of listings of other incumbent local exchange carriers. PNB included these listing when they were within the extended calling area of PNB's customers, as required by Commission rule. However, PNB did not deliver its directories to these non-PNB customers. PNB included the listings to assist its own customers' completion of calls within their local calling areas and to meet its regulatory obligations. *Id. at 18-19.*

109 Dex, on the other hand, has expanded the scope of its business beyond the business that was part of the transferred regulatory obligation. Dex does not simply include the listings of other LECs in the directories it publishes and delivers to QC customers, as was the policy when the operations were conducted within the Company's regulated operations. Dex publishes these listings as part of its publishing obligation to many of these local exchange carriers and delivers directories to all homes and businesses located within the geographic scope of their directories. This was not part of the business that was operated before 1984 and this portion of the business is not part of Dex's publishing agreement and obligation to QC. Therefore, the portion of the gain from the Dex sale attributable to the value of the business associated with non-Qwest listings should be excluded from any gain sharing calculation. *Id. at 19.*

110 Dex currently has publishing agreements with nine competitive local exchange carriers[63] in Washington and one incumbent local exchange carrier, Inland Telephone Company.

[63] Allegiance Telecom, AT&T, MCIMetro, Now Communications, Sterling International Funding, dba 1800 RECONEX, Sprint, Teligent, Time Warner Telecom and Worldcom.

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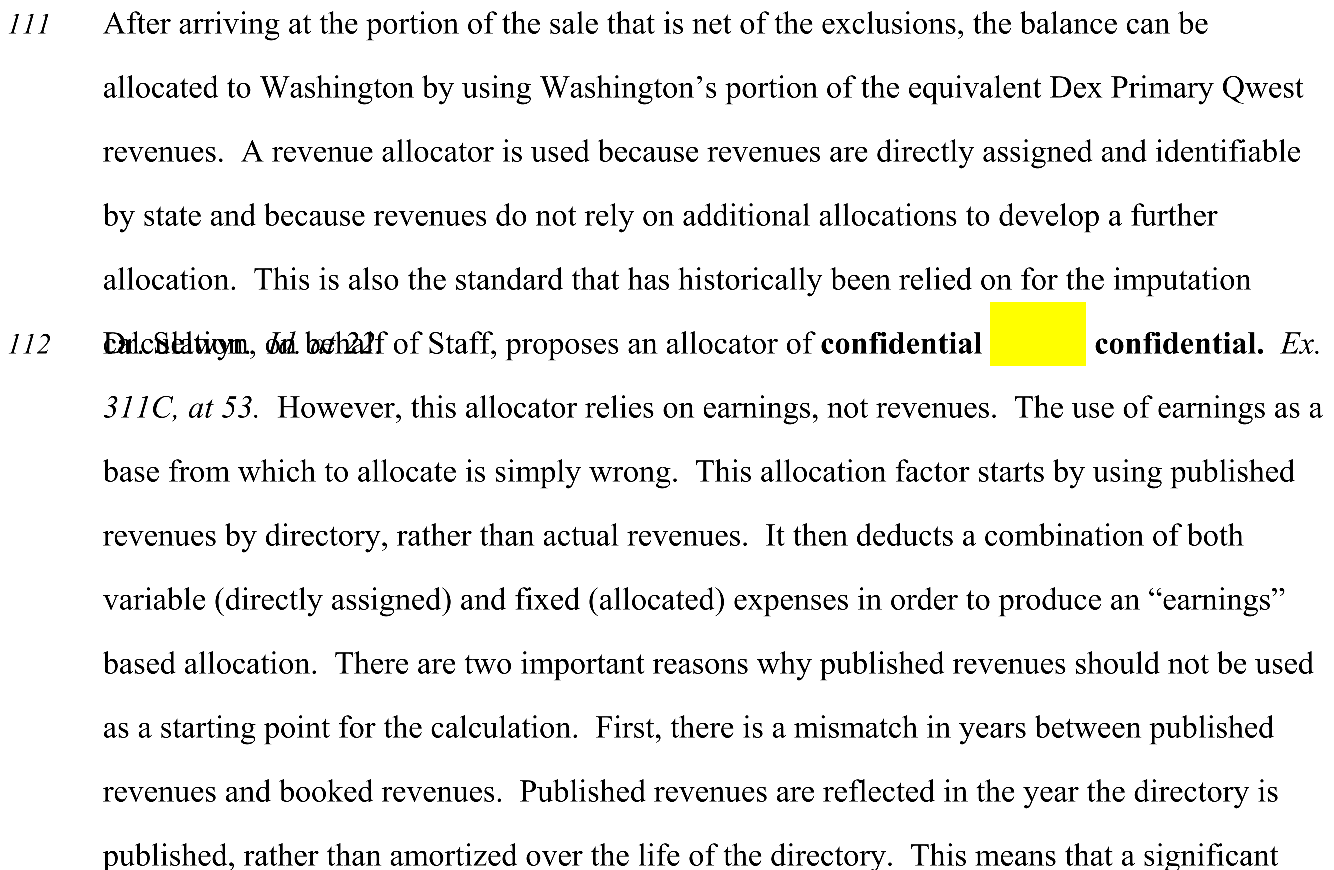
Additionally, Dex has listing agreements with eleven other incumbent local exchange companies in Washington, to include their listings in Dex directories, although Dex does not have the accompanying obligations as it does with Publishing Agreements. This means that Dex has expanded its business beyond the scope of the directory publishing business that was operated in the regulated company. Dex has the same obligations to the ten local exchange carriers and their customers that Dex has to QC and its customers. This part of Dex's business was not a part of the Company's regulated business. The business that was operated within the regulated Company operations includes only the portion of Dex's current business that is related to QC listings in Primary directories and the standard set by the imputation calculation in Docket Nos. U-89-2698-F/U-89-3245-P. *Id. at 20-21.*

C. The Appropriate State Allocator for Washington is 17.44%

111 After arriving at the portion of the sale that is net of the exclusions, the balance can be allocated to Washington by using Washington's portion of the equivalent Dex Primary Qwest revenues. A revenue allocator is used because revenues are directly assigned and identifiable by state and because revenues do not rely on additional allocations to develop a further allocation. This is also the standard that has historically been relied on for the imputation calculation. *Id. at 22.*



112 Dr. Selwyn, on behalf of Staff, proposes an allocator of **confidential** **confidential.** *Ex. 311C, at 53.* However, this allocator relies on earnings, not revenues. The use of earnings as a base from which to allocate is simply wrong. This allocation factor starts by using published revenues by directory, rather than actual revenues. It then deducts a combination of both variable (directly assigned) and fixed (allocated) expenses in order to produce an "earnings" based allocation. There are two important reasons why published revenues should not be used as a starting point for the calculation. First, there is a mismatch in years between published revenues and booked revenues. Published revenues are reflected in the year the directory is published, rather than amortized over the life of the directory. This means that a significant

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amount of revenue is recognized a year earlier than it is recognized on the financial books of Dex. Second, published revenues reflect revenues before any adjustments are reflected. Dr. Selwyn's method overstates actual booked revenues and understates booked expenses. The result is a significantly overstated allocation to Washington. *Ex. 131, at 22-23*.

113 Qwest's proposed allocations are consistent with the disposition approved by the Commission with regard to Contel Corporation's 1985 sale of its directory publishing subsidiary, Leland Mast Directory Company. In that case, it appears that Staff first allocated the gain on the sale to affiliated operations. *Ex. 131, at 23-24.* By removing the gain associated with the LCI, NewVentures, Secondary directories and non-Qwest listings, Qwest has similarly identified the "affiliated operations" of Dex. Another allocation was made to identify the "CTNW share of the gain" and this share was then allocated to Washington. It appears both these allocations were made on the basis of revenues. This is just what Qwest has done for this transaction – identified the portion of Dex's current business that relates to Dex's "affiliate operations" and allocated that portion to Washington on the basis of revenues.

D. <u>Determine an Appropriate Sharing of the gain Between Ratepayers and Shareholders</u>

114 Having determined the total gain amount to be allocated to Washington, that amount needs to be apportioned among ratepayers and shareholders. In the Accounting Order, the Commission speaks to an appropriate distribution of the realized gain on sale[64] and notes that imputation is not a substitute for the amortization of any value to be distributed in the event of a sale.[65] Nowhere in this or prior decisions, however, has the Commission indicated that upon such a sale 100% of the realized gain presumptively belongs to ratepayers. That is, however, essentially the position advanced by Staff in this docket. *Ex. 421, at 8 ("It is generally appropriate to use the gain on a sale to the benefit of the customers, and there is nothing about*

[64] *Accounting Order*, ¶ 168

[65] *Id.*, ¶ 172

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the circumstances of this transaction to support doing otherwise by allocating any part of the gain to the benefit of the company and its shareholders.").

115 As a separate corporation, Dex is not utility property on the books of QC. The Commission's description of the publishing business as a "regulatory asset" has not caused it to become utility property on QC's books. Consequently, if directory operations were not deemed a "regulatory asset," there would be no question that the gain belongs to shareholders. Assuming, however, the "regulatory asset" designation signals the Commission's intent to treat Dex as if it were utility property for purposes of determining gain disposition, that designation does not, as Staff seems to assume, resolve the gain disposition question; it only raises it.

1. Staff is Incorrect that 100% of the Gain Automatically Reverts to Ratepayers

116 As noted above, it is not the law in Washington that 100% of realized gain on the sale of utility property automatically belongs to ratepayers. Nor has the Commission established such a precedent. In the *Puget Sound Power* decision,[66] the utility held properties consisting of both raw, non-depreciable land and land with improvements. In all cases, however, the land became unnecessary for utility operations and was sold as surplus, much of it to an unregulated subsidiary at book value. The subsidiary, in turn, sold some of the properties at market value, retaining the gain. Nowhere in *Puget Sound Power* did the Commission say ratepayers were automatically entitled to the gain on the property. Instead, the Commission explained: "[T]he question is not whether the ratepayers must support the property [now] but whether their *past support* entitles them to a sharing of gain on its transfer."[67] The Commission found "compelling" the policy interests which are discussed in *Democratic Central Committee*[68] and found persuasive the argument "that, because the ratepayers have shouldered the risks of

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[66] *WUTC v. Puget Sound Power and Light Company*, Case No. U-85-53, Second Supplemental Order, 74 P.U.R. 4th 536 (1986).

[67] *Puget Sound Power,* at 21 (emphasis added).

[68] *Democratic Central Committee v. Washington Metropolitan Transit Commission*, 458 F.2d 786 at 806.

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ownership, they should share in the benefit at sale."[69]

117 In the *Centralia* decision[70] the Commission considered the appropriate distribution of the gain from the sale of the Centralia steam plant, coal mine and related facilities. The Commission followed the path of many jurisdictions and employed the *Democratic Central Committee* principle that "the right to gain follows risk of loss and that the benefit of the sale should follow those who bore the burdens associated with the operation of the assets."[71] The Commission's decision is replete with language making clear that sale of utility property requires a gain sharing analysis – and not an automatic award of 100% of the gain to ratepayers.[72] Were the latter the standard, an analysis would be unnecessary.[73]

2. Application of the Democratic Central Committee Principles Demonstrates that the Settlement Agreement is More Than Fair to Ratepayers

118 The gain allocation principles set forth in *Democratic Central Committee* require a two-step analysis. The first step is to determine who—as between ratepayers and shareholder—bore the risk of capital loss. If that determination cannot be made, then it is necessary to take the second step and determine who bore the burden of the utility activity in question.[74] Qwest witness

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[69] *Puget Sound Power,* at 22.

[70] *In re the Matter of the Application of AVISTA* Corporation for Authority to Sell Its Interest in the Coal-Fired Centralia Power Plant, Docket No. UE-991255; In re the Matter of the Application of PACIFICORP for an Order Approving the Sale of its Interest in (1) the Centralia Steam Electric Generating Plant, (2) the Rate Based Portion of the Centralia Coal Mine, and (3) Related Facilities; for a Determination of the Amount of and the Proper Rate Making Treatment of the Gain Associated with the Sale, and for an EWG Determination, Docket No. UE-991262; In re the Matter of the Application of Puget Sound Energy, Inc. for (1) Approval of the Proposed Sale of PSE's Share of the Centralia Power Plant and Associated Transmission Facilities, and (2) Authorization to Amortize Gain over a Five-Year Period, Docket No. UE-991409; Second Supplemental Order, Order Approving Sale with Conditions (2000) (*Centralia).*

[71] *Centralia*, pp. 57-58.

[72] The Commission indicated that this decision was "not based on some a pre-conceived formula, but on the equities of this distinctive case." *Id.* at 65. The Commission concluded its analysis by stating that "[a]fter studying the risks and benefits of the proposed sale and after examining the accounting gain and establishing an *allocation* of that gain that strikes a *fair balance* between ratepayers and shareholders, we find that the proposed sale is in the public interest." *Id.* at 69 (emphasis added).

[73] Commissioner Hemstad dissented from the majority opinion in *Centralia,* indicating that he believed ratepayers should receive 100% of the gain from that sale. It is clear, however, that Commissioner Hemstad was not advocating a de facto "100% to ratepayers standard." Rather, he agreed with the majority that an appropriate allocation of gain required an analysis under *Democratic Central Committee's* risk and burden principles. In that particular case, he believed that those principles required 100% of the gain to be awarded to ratepayers.

[74] *Democratic Central Committee v. Washington Metropolitan Transit Commission*, 458 F.2d at 806 ; *Illinois*

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Philip Grate is the only witness in this docket who undertook a historical analysis of the facts to determine the allocation of risks and burdens.

119 Staff makes no allowance for any allocation of any of the gain to Qwest shareholders. Instead, Staff's witness, Dr. Lee Selwyn, argues ratepayers are entitled to 100% of the gain because, since 1923, the directory publishing activity has been an integral part of the regulated telephone business supported by ratepayers. *Ex. 311, at 61-65.* Staff's argument fails as a matter of fact and law. As a matter of law, Staff's "integral part" test is a straw man. The two-step test under *Democratic Central Committee* necessarily presumes the assets and utility activity in question are an integral part of a regulated utility business. Were that not the case, ratepayers could have no claim whatsoever.

120 Factually, Staff's argument fails on several counts. First, Staff fails to address the first step of the two-step test. Staff makes no effort to show that ratepayers bore the risk of capital losses on the intangible assets that Dr. Selwyn identifies. *Ex. 311, at 77-99.* Second, Staff's analysis intentionally disregards 33% of the relevant history of risks and burdens. *Ex. 311, at 61*; *Ex. 110, at 33.* Third, Staff fails to apply its analysis to the particular assets being sold and instead, incorrectly applies its test to Qwest's business as a whole. *Ex. 311, at 61-65; Ex. 110, at 20-22.* Finally, Dr. Selwyn's analysis is conclusory instead of factual. *Ex. 110, at 36.*

121 In contrast, Mr. Grate's careful factual analysis, covering directory operations from their inception in Washington, clearly demonstrates that ratepayers have never borne the risk of capital loss on intangible directory assets in Washington because they have never been in rate base. *Ex. 101, at 17; Ex. 110, at 29.* It is axiomatic that ratepayers cannot bear the risk of capital loss on assets not in rate base, because there is no mechanism to impose cost recovery on ratepayers for such assets. *Ex. 101, at 24; Ex. 110, at 29-30.*

122 Importantly, there is no dispute that the gain on the Dex sale is largely attributable to the

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Public Telecommunications Association v. Federal Communications Commission and United States of America, 326 U.S. App. D.C. 1 at 43-44; 117 F.3d 555 (1997)).

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intangible assets, including goodwill, which have never been in rate base, even prior to divestiture in 1984. Ratepayers can have no effective claim to this portion of the gain based on the principles set forth in *Democratic Central Committee* that the Commission employed in *Puget Sound Power* and *Centralia*. With regard to tangible directory assets, Mr. Grate's chronological analysis of directory operations demonstrates that ratepayers, again, by very definition, could not have borne the risk of loss on such assets until they were subject to cost of service regulation in Washington. *Ex. 101, at 12-18.* This did not occur until 1923 at the earliest. *Id*. Further, subsequent to the conveyance of the tangible directory assets to U S WEST Direct in 1984, and this Commission's approval of the transfer of those tangible assets, they have not been in Qwest's rate base. *Id*. at 22. Since divestiture and conveyance to USWD, directory operations have been conducted in a separate affiliate. *Ex. 61, at 14-15*

123 Accordingly, for roughly 50% of the period for which Qwest or its predecessors have published directories in Washington, ratepayers have borne no risk of capital loss even with regard to the tangible directory assets. *Ex. 101, at 25*. Mr. Grate's testimony in this regard is uncontested, though Staff attempts to shrug off the early years of directory operations as irrelevant. *Ex 311, at 61*. Of course, as Mr. Grate points out, the early years of operation were the period when Qwest's operations, including its directory operations, were most subject to competitive and other risks. *Ex. 101, at 9*. Ratepayers bore none of these risks. *Id*. at 17-18.

124 *Democratic Central Committee* directs that only if a court or commission cannot determine who bore the risk of capital losses should it then consider who bore the burden of the utility activity.[75] Mr. Grate's testimony establishes that this Commission can, in fact, determine who bore the risk of capital losses on tangible and intangible directory assets under the first step of *Democratic Central Committee* test. But even under the second step of the test ratepayers have no better claim to the gain - and they certainly have no valid claim to 100% of the gain. Since

[75] *Illinois Public Telecommunications Association v. Federal Communications Commission and United States of America,* 326 U.S. App. D.C. at 44.

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1918, directory operations have been profitable, and directory revenues have exceeded directory expenses. *Ex. 103, at 9-10; Ex.104*. For this reason, directory operations have always been a source of contribution to cost-of-service regulated rates for basic, local exchange services. *Ex. 101, at 19*. This is undisputed, and recognized by each of the parties in this docket. Post-divestiture, directory operations have continued as a source of contribution to local exchange services through directory revenue imputation. *Ex. 110, at 3*. Simply stated, this contribution from directory operations has at all times benefited, and never burdened ratepayers. *Id. at 22-23*. The rates they have paid for basic, local exchange services have at all times been lower then the rates they would otherwise have paid, absent this contribution from directory operations. *Id.*

125 In this regard, it is critical to point out that the second step of the *Democratic Central Committee* test, the "burden of utility activity" test, does not include a risk factor. The question is not whether ratepayers were at risk to bear the burden of a particular utility activity; the question is whether they actually bore the burden of the utility activity.[76] Rates have never been set to support directory operations. Thus, Washington ratepayers have enjoyed a significant benefit from directory operations, and have never been burdened by those operations. The equitable principles upon which the court in the *Democratic Central Committee* based its two-step test do not countenance rewarding ratepayers who have not been actually burdened.[77]

126 For that matter - and even though the test is actual burden, not risk of burden - it is clear that had Dex's directory operation ever ceased to generate revenues in excess of their costs, ratepayers would not have been at risk to support directory operations under the directory imputation regulatory scheme of the past two decades. In its decision in the 1995 rate case the Commission clearly indicated that the imputation calculus is, in fact, based on "excess" revenues: "for regulatory purposes in calculating performance, the Commission imputes the

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[76] *Democratic Central Committee v. Washington Metropolitan Transit Commission*, 458 F.2d at 808-811.

[77] *Id.* at 821.

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'excess' revenues to USWC results of operations."[78] Were there no "excess" revenues, there could be no imputation amount. Thus, there has been no possibility of a negative imputation.

127 Yet Dr. Selwyn's premises his risk analysis on just such a mistaken assumption. He testified that he believed that imputation would operate to require ratepayers to actually support directory operations if they were to lose money. *Tr. 904.* Because this premise is incorrect, the conclusion drawn from it (that ratepayers bore a risk or burden) is wholly unsupported.

128 Mr. Grate's analysis – the only factually based risk and burdens analysis before this Commission – demonstrates that ratepayers, for the most part, have neither borne the risk of capital loss nor the burden of the directory operations utility activity. The point of this discussion, however, is not to ask the Commission to grapple, at least not directly, with this issue of an allocation of the gain that strikes a fair balance between ratepayers and shareholders. Rather, Mr. Grate's analysis demonstrates that the Settlement Agreement, which provides to ratepayers far in excess of 50% of the gain as any party calculates that gain, is more than reasonable. The Commission should reject Staff's contention that ratepayers are presumptively or actually entitled to 100% of the gain.[79] The Commission should adhere to its past practice of balancing the ratepayers' and shareholders' respective interests in that gain. The Commission should find that, in light of an appropriate risks/burdens analysis, the benefits conferred on ratepayers by the Settlement Agreement are more than adequate and are appropriate.

VI. THE SETTLEMENT IS IN THE PUBLIC INTEREST AND THE SALE SHOULD BE APPROVED WITHOUT FURTHER CONDITIONS

129 After many months of negotiations, almost all of the parties to this proceeding were able to reach a settlement of the disputed issues. The parties to the Settlement Agreement include Public Counsel, AARP, WeBTEC, the Department of Defense, Dex Holdings, and Qwest

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[78] Fifteenth Supplemental Order, p. 34. *See also 1989 Settlement Agreement, at ¶ 18.H.a.*

[79] Indeed, Dr. Selwyn admitted that under Staff's view, ratepayers get the better of 100% of the gain or the NPV of the expected future imputation benefits. Based on this recommendation it is clear that Staff believes that ratepayers should be in a no-lose, no-risk situation. *Tr. 861.*

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("Settling Parties"). All of those parties provided written and oral testimony in support of the Settlement Agreement. They explained why it is in the public interest for the Commission to approve the sale of the Washington assets and operations of Dex without conditions other than those set forth in the Settlement Agreement. *Exs. 93, 306, 286, 264.*

130 All of the parties to the Settlement Agreement have agreed to support the sale with the conditions set forth in the Settlement Agreement in lieu of the positions they may have taken in their previously filed testimony. *Ex. 2, at ¶ 10.* The Commission has all of that previously prefiled testimony before it in the record, and it is clear that the Settlement Agreement represents compromises by all parties. That is of course the nature of a settlement, where parties trade litigation risk for the certainty of the outcome agreed upon in the settlement.

131 The Commission knows that all of the parties to the Settlement, except Dex Holdings, have vigorously litigated the yellow pages issue for many years. The Commission may conclude from that that the other parties to this proceeding would not have settled if they did not believe the Settlement Agreement represented a fair and defensible outcome under the facts of this case and applicable law. The Commission may observe that all of the important interests are represented in the settlement – consumers, government, seniors, business, and shareholders, as well as the broader public interest. Those factors alone should be persuasive to the Commission of the reasonableness of the settlement. However, the terms of the Settlement Agreement also lend strong support to its acceptance as a full and fair resolution of all of the issues in this case.

A. The Terms of the Settlement Agreement are in the Public Interest

132 The terms of the Settlement Agreement include an up-front bill credit to customers and annual revenue credits to apply in any ratemaking proceeding in order to flow back to the Washington ratepayer a substantial portion of the Dex gain. These mechanisms are fair and reasonable, and balance some parties' desire to have an immediate payment with a recognition that it is in the

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public interest for Qwest to have the sale proceeds available to pay down debt. Additionally, the Settlement Agreement preserves the ratepayer benefits of imputation with an imputation-like revenue credit.

133 The Settlement Agreement includes five provisions that satisfy the Commission's public interest considerations with regard to the sale. These provisions include: a one-time bill credit to customers of $67 million; an annual revenue credit of $110 million per year for the first four years and $103.4 million per year for the following eleven years after the sale is approved (total of 15 years); Qwest's commitment that it will not petition to remove the Customer Service Guarantee Program, as outlined in Qwest tariff WN U-40, Section 2.2.2.B (sheets 27 through 32) for two years; Qwest's commitment that it will address certain Washington Telephone Assistance Program/Tribal Lifeline process and training issues; and Qwest's commitment that it will work with WeBTEC and the Department of Defense on rate stability issues in association with their client's services.

B. The Settlement Agreement Meets the "No Harm" Standard that the Commission has Articulated in Prior Orders

134 The Settlement Agreement is clearly in the public interest. Using the guidelines cited by the Commission in *Colstrip* as benchmarks,[80] the Settling Parties believe that the Sale transaction in conjunction with the Settlement Agreement, at the very least, does not harm the public interest. Set forth below is a discussion of each of the guidelines the Commission has

[80] Docket No. UE-990267, Third Supplemental Order, at pp. 9-10:

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

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

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

4. The jurisdictional effect of the transaction should be consistent with the Commission's role and responsibility to protect the interests of Washington gas and electricity ratepayers.

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considered and endorsed in the past, with a discussion of how the Settlement Agreement satisfies that consideration in this case.

1. No Harm to Ratepayers

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

136 The Settlement Agreement meets this standard in that it offers ratepayers protection from rate increases for an extended period by replacing the current benefit of imputation with a revenue credit for 15 years. Furthermore, the Settlement Agreement provides for a one-time bill credit of $67 million, effectively making a direct payment to ratepayers for partial disposition of the gain on the sale.

137 During the hearings in this case, concerns were raised about whether and how the revenue credit would be "funded," contrasting it with imputation, which Staff claims was funded by Dex revenues. The Commission also expressed concerns about this issue via questions from the bench of various witnesses. Qwest believes that the concern is the result of a misunderstanding of how imputation has worked in the past, and is easily addressed.

138 The revenue credit will be funded in the same way that imputation was funded – through the parent company's acceptance of a lower rate of return for QC's Washington intrastate operations. Imputation was *never* a cash payment from either Dex or the parent to the local operating company. *Ex. 131, at 37; Tr. 489*. Indeed, imputation was never reflected anywhere on QC's books, only in regulatory reports to the Commission. As the Commission and the Courts have recognized, imputation has been a ratemaking adjustment, not a transfer of funds.[81]

139 Staff may counter that although that argument is correct, imputation was funded at the parent company level through Dex revenues, and that funding source will no longer be in place,

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[81] *U S WEST Communications, Inc. v. WUTC,* 134 Wash.2d at 101-102.

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leading back to the concern that the revenue credit will not be "funded." However, this is simply untrue. The sale reflects a monetization of the Dex revenue stream. *Tr. 1135.* Thus, while Qwest may not have the ongoing annual revenues from Dex, it will have an additional $7.05 billion in sale proceeds with which it can "fund" the revenue credit. Or, more likely, Qwest will use those proceeds to improve liquidity and take debt off of its books, thereby freeing up income that would otherwise have been used to service the debt. This creates somewhat of an offset at the parent level. *Tr. 1133-1135.* Thus, concerns about "funding" the revenue credit are unfounded.

2. Balancing of Interests

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

141 The sale of Dex is in the public interest at this time because it balances the interests of ratepayers, shareholders, and the broader public. As discussed elsewhere in this brief, the Commission is bound to consider the impact of a possible bankruptcy filing on ratepayers, affected companies, employees, and shareholders. The sale of Dex makes such a filing less likely, thereby avoiding numerous negative impacts. Those negative impacts include potential adverse effects on Qwest employees, suppliers and ratepayers. See section VII.A.4. below.

142 In addition, the sale is well-timed in terms of realizing substantial value from the asset while avoiding risks associated with operating the publishing business in the future. While Staff has attempted to brush off these risks as overstated (*Ex. 370, at 8*), it is clear that they are very real. The printed directory has been losing usage and advertisers over the past 5 years at least. *Tr. 430.* The business faces risks from both technological change and competitive entry. *Tr. 815.* The sale monetizes the value of the business now, to the benefit of both ratepayers and shareholders, and thereby avoids facing those business risks in the future.

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143 The Settlement Agreement meets the objectives of this principle in that it provides ratepayers short, medium and long term benefits (bill credits, continuation of Customer Service Guarantee Program, and annual revenue credits, respectively) while allowing Qwest the flexibility to address its financial situation. The broader public also benefits through the economic effects of the ratepayer benefits and because a financially stable Qwest is able to continue to invest in the state, provide high quality service to its customers, and meet its obligations, including payroll and employee benefit expenses. Additionally, it is clear that the Settling Parties took all of these elements into consideration in reaching the agreement they did.

144 Staff's proposal, on the other hand, offers no such balancing of interests.[82] Staff's first recommendation – that Qwest be driven towards bankruptcy instead of being allowed to sell Dex, reflects a point of view that can fairly be described as unbalanced and extreme. Clearly, such a result would produce a total loss of value for shareholders, would likely deprive the Commission of any say over the disposition of Dex proceeds, and fails to factor in the broader impact to the general public of having the state's largest telecommunications utility in bankruptcy. See section VII.A.4. below. Staff's second recommendation fares little better. Although Staff attempts to present its proposal as a balancing of interests, Qwest has shown that it produces the same result as denying the sale. See section VII.B. below. Thus, there is no meaningful balancing of interests in Staff's proposal.

3. Impact on Competitive Markets and the Public Interest

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

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[82] In setting out Staff's primary and alternate recommendations in his direct testimony, Dr. Blackmon offered no explanation as to how Staff's proposals reflect a balancing of the interests of the ratepayers, *shareholders* and the public interest. Staff's concerns, as articulated in Dr. Blackmon's direct testimony, focus solely on avoiding any possible rate increase in the future and extracting maximum payout under the MRI. *Ex. 370, at 3, 27-28.* Dr. Blackmon's testimony in this regard appears inconsistent with Staff's role, which is to balance ratepayer and shareholder interests. *Tr. 1312.*

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146 Although the Settlement Agreement extends the current benefit of imputation to ratepayers for an extended time into the future (15 years), it is not an endless subsidy that has the potential to distort or impair the development of competitive markets indefinitely. That cannot be said of Staff's alternate proposal which would impact markets for 50 years.

4. Jurisdictional Effect of the Transaction

147 Finally, the jurisdictional effect of the transaction should be consistent with the Commission's role and responsibility to protect the interests of Washington ratepayers. As Mr. Reynolds noted in his rebuttal testimony, this principle has in the past only been articulated with respect to gas and electric utilities. However, it is clear that if a proposal for settlement satisfies the first three principles, as the Settlement Agreement does, it also protects the interests of Washington ratepayers.

C. 15 Years is an Appropriate Period for the Revenue Credit

148 The period of the revenue credit is 15 years, which parties have supported as a reasonable period over which to flow the benefit of the transaction back to ratepayers. Staff has criticized this proposal, and suggests that an appropriate period of benefit must match the period of either the publishing agreement (50 years) or the non-compete agreement (40 years). *Ex. 370, at 25.*

149 Staff's criticism rests on a fundamental misunderstanding of the relationship of the value of the transaction to the time periods proposed. As Qwest has demonstrated, the value of the business is fully reflected in the realized sale price. This value is flowed back to ratepayers in a shorter period of time than the agreements are in existence, but that does not create a "mismatch."

150 If the value were to be stretched out over a longer period of time, the revenue credit would simply be much smaller, and that is not what the Settling Parties agreed upon as the proper resolution of this issue. As Mr. Reynolds explained in his testimony in support of the Settlement Agreement, the Settlement Agreement is based on the realized price for Dex, which includes the value of the 50-year publishing agreement and the 40-year non-compete

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agreement. The gain disposition provisions associated with the settlement (i.e., the up-front bill credit and the 15 years of revenue credits) actually return the 40 and 50 year term value of these agreements in a shorter time period to ratepayers (i.e., 15 years). *Ex. 93.*

D. The Commission Should Affirm That Any Affiliated Transactions Associated with the Sale are Approved

151 As Qwest pointed out in its application, the sale transaction involves certain transactions that may technically be affiliated interest transactions under Chapter 80.16 RCW. *Application, at 9-11.* Additionally, the ongoing publishing agreement between QC and Dex Holdings is likely a management or service contract that falls within the scope of those affiliated transactions governed by RCW 80.16.010. As a part of acceptance of the Settlement Agreement and approval of the sale, the Commission should affirm that those transactions, as well as the compensation associated with them, are approved without further conditions.

VII. STAFF'S RECOMMENDATIONS ARE NOT IN THE PUBLIC INTEREST

A. Staff's Primary Recommendation is Unsupported by Fact, Contrary to the Public Interest and Contrary to Law

152 Staff urges the Commission to deny the sale. *Ex. 370, at 3; Tr. 1459.* Staff makes this recommendation despite having no appreciable understanding of how bankruptcy works or of the likely consequences of a Qwest bankruptcy, and in the face of Qwest's expert testimony about the risks of bankruptcy. Staff concludes that, even if denial of the sale makes a QCI bankruptcy more likely, such a bankruptcy poses little risk for QC and QC's ratepayers. In addition to being at odds with this Commission's and the Washington Supreme Court's precedent, Staff's primary recommendation is uninformed and contrary to the public interest.

1. The Sale of Dex is Essential to Avoid a Likely Bankruptcy

153 Qwest has consistently explained that the sale of Dex is critical to Qwest's delevering strategy and that, without the closing of both phases of the sale, bankruptcy was and is likely. *Ex. 61, at*

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9; Ex. 171, at 3, 11; Ex. 172, at 21. The evidence in the record supports Qwest's assertion and shows that Qwest is not simply crying wolf, as Staff claims.[83]

154 But for the Dex sale agreements, Qwest would not have been able to conclude negotiation of the ARCA. *Ex. 171, at 8; Tr. 665.* The ARCA had two critical impacts on Qwest. First, it extended $3.4 billion of maturities that were coming due in May 2003 under the Amended Credit Facility.[84] *Ex. 172, at 15-16.* Second, it relaxed certain loan covenants (including the debt-to-EBITDA ratio) that QCI would very likely have violated by October 2002 in the absence of the ARCA. *Id. at 16; Ex. 171, at 7.* Breach of those covenants would have constituted an event of default under the Amended Credit Facility, and would have allowed Qwest's syndicate of lenders to accelerate the obligation and demand payment in full immediately. *Ex. 83.*[85] Given Qwest's lack of access to the commercial paper market (*Ex. 172, at 9-10*) and its overall financial condition, the August 2002 agreement to sell Dex very likely prevented a QCI bankruptcy from occurring in 2002.

155 Even with the ARCA in place, Qwest's cash flow projections show that, absent the closing of the Rodney transaction, **highly confidential** **
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** **highly confidential.**

156 As Mr. Cummings describes in his testimony, the successful sale of Dex, along with negotiation of the ARCA, the debt exchanges and QC's recent borrowing, represents the

[83] In his Supplemental Testimony, Staff witness Blackmon alleges that "Qwest has overstated both the likelihood of a bankruptcy and the probable consequences to QC customers in a bankruptcy scenario." *Ex. 421, at 3.*

[84] Mr. Cummings' Table B displays the repayment schedule under the ARCA and other obligation assuming the Rodney transaction closes. *Ex. 171, at 20.* Should the Rodney transaction fail to close, the $1.5 billion shown in Table B to be owing in 2003 will be due as follows: $750 million (the Dex term loan) will be due in 2004 and $750 million (ARCA) will be due in May 2005. *Ex. 83 (QCII 8-K 9-5-02, at 29, 33, 35-36).*

[85] *See Ex. 83 (QCII 8-K 3-18-02, at 9, 11; QCII 10-Q 5-15-01, at 89-92).*

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foundation necessary to permit Qwest to execute on its financial and business plan in the future. *Ex. 171, at 11; Ex. 172, at 19; Tr. 664.* Rating agencies Moody's and Fitch have declared that, without the funds from the close of Rodney, QCI will likely be unable to meet its repayment obligations coming due in the next few years and will likely face further ratings downgrades (thus increasing its borrowing costs and decreasing its access to capital). *Exs. 195, 196, 198.* All of these factors could lead to a forced bankruptcy filing in the next few years, or even possibly earlier in order to consummate the sale of the remaining Dex properties if the Commission denies or frustrates the sale.

2. Staff Has Not Proven that Bankruptcy is Unlikely

157 While Staff witness Blackmon asserts that Qwest is exaggerating the company's precarious financial position and the likelihood of bankruptcy, Staff has offered little support for this assertion.[86] Instead, Staff takes the position that, even if denial of the sale makes bankruptcy more likely, the Commission should not be concerned, as bankruptcy will not adversely impact QC or QC's customers. Staff's position is remarkably uninformed.

3. Staff's Portrayal of Bankruptcy is Not Supported by Fact

158 Staff's pre-filed testimony contains numerous predictive statements aimed at assuring the Commission that a QCI bankruptcy will not involve QC and will cause no harm to (and might actually benefit) QC and QC's customers. Those statements include, among others,[87] the following:

- "Even if QCII were to seek bankruptcy protection, it is neither automatic nor even likely that QC would also declare bankruptcy." *Ex. 370, at 13.*
- "Indeed, QC might even be better off with its parent in bankruptcy." *Id.*

[86] Staff appears to be alone in believing that Qwest is exaggerating the looming threat of bankruptcy. For example, Public Counsel and DOD have always taken the position in this case that the Commission should approve the Dex sale given the realistic threat of bankruptcy facing Qwest should the Rodney transaction fail to close and the attendant harm that would befall ratepayers. *Ex. 271, at 3; Tr. 597-599; Ex. 291C, at 44-45.*

[87] *See also Ex. 370 at 14:2-7, 16:4-7, 17:1-2; Ex. 421, at 3:6-11; Ex. 431, at 4:2-4; 9:17-10:5.*

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- "[A] bankruptcy filing by QCII would not necessarily lead to further layoffs or spending reductions at QC and, as I discussed earlier, could even improve operating conditions at the telephone company." *Id. at 15.*
- "The harm to customers and to the public interest would be smaller in a bankruptcy scenario than in the scenario that Qwest offers in this proceeding." *Id. at 17.*
- "Q. If QCII were to seek bankruptcy protection, would QC also need to declare bankruptcy? A. No, not necessarily. QC would likely have no reason to seek bankruptcy protection, because it would remain a financially sound corporation. . . . . The creditors may become the owners of QC, but it would likely not be in their interest to disrupt the telephone company operations which may result in a possible decline in profits." *Ex. 431, at 8-9 (bold removed).*
- "QC's witnesses would have the Commission believe that it should approve this sale in order to avoid bankruptcy, which they imply would be very harmful to customers….Indeed, a bankruptcy filing may actually improve circumstances for the telephone company and its customers." *Id. at 9-10.*
- "Note that I am not offering any sort of legal opinion as to the actual status of this 'revenue credit' [that is provided for in the stipulation] in the event of QCII bankruptcy, but would observe that its status is clearly highly questionable at best." *Ex. 363, at 6.*

159 Staff offers these rather bold predictions notwithstanding the fact that it did not put forward even a single witness with any educational, practical or professional experience or qualifications to meaningfully opine on bankruptcy law or the bankruptcy process. None of Staff's witnesses has received formal educational training regarding bankruptcy, has participated in any capacity in a bankruptcy proceeding or has published on the subject. *Exs. 386, 387, 400, 442-444.* Nor did Staff's witnesses review any bankruptcy decisions or confer with any bankruptcy experts prior to filing testimony that speculates at length about bankruptcy issues. *Exs. 391, 403, 441.* Instead, Staff's witnesses rely on their general regulatory and telecommunications background and on the still-unresolved bankruptcy case involving Enron and its subsidiary, Portland General Electric ("PGE").[88]

[88] Staff pronounces that the Enron-PGE situation is analogous to the QCI-QC situation and that the Commission

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160 In an attempt to deflect Qwest's inquiry into the qualifications of its witnesses, Staff declares that while Dr. Blackmon and Ms. Folsom are not qualified to offer expert testimony on bankruptcy law or procedure, they are somehow qualified to provide expert testimony on "the impact of bankruptcy on interested persons." This is a distinction without a difference.

161 A person lacking a thorough understanding of how the bankruptcy process works and the priorities and restrictions guiding the bankruptcy court's decisions can not reliably opine as to how interested persons will be impacted by bankruptcy since the assumptions underlying those opinions may be false. For example, both Dr. Blackmon and Ms. Folsom testify that, even if QCI files bankruptcy as a result of Commission denial of the Dex sale, it is unlikely that QC will also file bankruptcy because QC is financially strong. *Ex. 370, at 13; Ex. 431, at 8.* But, as Mr. Mabey explains, insolvency is not a prerequisite for filing bankruptcy. *Ex. 211, at 3, 9.* QC may be placed in bankruptcy in order to consummate a bankruptcy sale of Dex that includes a publishing agreement and non-compete agreement binding on QC. *Id. at 9.* Because Staff's underlying premise (that a financially sound QC cannot or will not file bankruptcy) is incorrect, its recommendation stemming from that premise has no value. Given the magnitude of the issues involved, Staff's willingness to make uninformed predictions about what might or might not befall QC and ratepayers in the event of a QCI bankruptcy is simply irresponsible.

4. A QCI Bankruptcy Would Not Serve the Public Interest, Especially Compared to the Known and Certain Benefits in the Settlement

162 A bankruptcy involving QCI holds considerable risks, not only for Qwest employees and shareholders, but also for QC and its customers. *Ex. 64C, at 12-14; Ex. 178, at 5; Ex. 211, at 17; Tr. 1026-1027.* Given the benefits guaranteed to QC customers if the Commission

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should take comfort from the Enron case that a regulated subsidiary can survive its unregulated parent's bankruptcy without harm. *Ex. 370, at 17; Ex. 431, at 2-9.* The folly of viewing the yet-unresolved Enron-PGE case as either a parallel to the QCI-QC circumstance or as conclusive proof that a regulated subsidiary can survive unscathed the bankruptcy of its unregulated parent is described by Mr. Cummings and Mr. Mabey. *Ex. 178, at 5-9; Ex. 211, at 13-16.*

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approves the Settlement Agreement, these risks seem even more untenable.

163 If QCI were to file bankruptcy, it is likely that QC itself would be pulled into bankruptcy, perhaps in order to facilitate the sale of Dex through the bankruptcy court. *Ex. 211, at 9.*[89] A QC bankruptcy could cause substantial disruption, could lead to layoffs, decreased capital investment in the state, an inability to roll out new and improved services and perhaps lower service quality. *Ex. 178, at 4-5; Ex. 211, at 17.* A QC bankruptcy would also very likely lead to additional downgrades of QC's credit and bond ratings. QC customers will not win under such a scenario.

164 In addition, it is very possible that Dex would be sold through bankruptcy to satisfy the indebtedness of QCI and QSC. As Mr. Mabey explains, under such a scenario, the Commission will have little or no voice in approving or conditioning the sale, in distributing any proceeds to ratepayers or in making post-bankruptcy ratemaking orders that attempt to continue imputation or a similar ratepayer benefit that would be inconsistent with the bankruptcy court's sale of Dex and disposition of proceeds. *Ex. 211, at 7-10.*[90]

165 Ratepayers have no cognizable claim to any proceeds in the event of a bankruptcy sale of Dex. The Bankruptcy Code recognizes and prioritizes the claims of different classes of creditors. Fully secured creditors hold the highest level of priority, followed (in simplified order) by administrative claimants, general unsecured creditors and, finally, owners. *Id. at 4-6, 8, 12, 17.* Persons do not have any bankruptcy claim against a debtor or a debtor's assets by virtue of their status as a ratepayer of the debtor. *Id.* As to the ownership of Dex, the bankruptcy court will respect the formal, legal ownership of the asset (i.e., that it is owned by Qwest Dex

[89] On cross-examination, Mr. Mabey indicated that the Commission could best protect against a subsequent QC bankruptcy (in the event that QCI subsequently files bankruptcy) by permitting the Dex sale to go forward. He explained that consummation of the sale (including the publishing and non-compete agreements) would likely lessen QCI's incentive to place QC into bankruptcy. *Tr. 729.*

[90] *See also In re Pacific Gas & Electric Co.,* 273 B.R. 795, 819 n.29 (Bankr.N.D.Cal. 2002) (stating that injunction against regulating authority would be appropriate if regulatory efforts to engage in imputation when it comes to ratemaking were perceived as attempt to circumvent Bankruptcy Court order confirming plan that preempted state and regulatory law).

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Holdings, Inc. and by QSC) and will likely ignore regulatory treatment of Dex as a "regulatory asset" of QC. *Id. at 8.* Whereas the Settlement Agreement offers ratepayers a $67 million upfront bill credit and 15 years of guaranteed revenue credits comparable to continued imputation, ratepayers will likely not realize anything if the Commission denies the sale and Dex is sold through bankruptcy.

166 Furthermore, QC itself may very well be sold in order to raise funds to partially repay QCI's and QSC's creditors. *Id. at 12.* In such event, this Commission again will likely lose all influence to control to whom, for what price and under what conditions QC is sold. *Id.* While Staff speculates that QC will be better off because it will obtain a new owner free of high debt levels and ethical and legal complications (*Ex. 370, at 14*), its speculation is undermined by its admission that it has no idea who would buy QC, for what price or under what conditions. *Ex. 398.* In reality, neither Qwest nor Staff is in any position to credibly predict who might buy QC in the event of a QCI bankruptcy. For Staff to suggest that QC would be better off is pure conjecture. Staff acknowledges that reviewing potential utility acquisitions is an important Commission function. *Ex. 397; Tr. 1412.* Nevertheless, it suggests the Commission push Qwest in a direction in which QC might well be sold without any Commission oversight.

167 Finally, Staff's suggestion that QC's value will motivate QCI's creditors to continue to operate (rather than sell) QC in conjunction with the directory business is at odds with how the bankruptcy process works. Staff admits it does not know the identity or interests of QCI's and QSC's creditors. *Ex. 393.* Those facts are critical given that different creditors have different motivations. A creditor which provided unsecured credit to QCI at a discount (e.g., by buying QCI bonds at sharp discounts) will likely have a shorter investment horizon and may be willing to "cash out" for less than 100 cents on the dollar. Another unsecured creditor, perhaps a lender which did not obtain its position at a discount, may have greater motivations to run QC as a going concern in order to recoup as much of its investment as possible over time. *Ex. 211, at 18.* The bottom line is that bankruptcy is a high-risk, extremely uncertain proposition, and

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Staff's eagerness to push QCI in that direction is puzzling.

5. Closing Around Washington is Not Guaranteed and May Not be Desirable

168 There was considerable discussion during the evidentiary hearings about the possibility of Qwest and Dex Holdings "closing around Washington" – that is, closing a renegotiated Rodney transaction as to every state other than Washington. Such an outcome would require considerable renegotiation between the buyer and seller and is not guaranteed to result in an outcome satisfactory to either buyer or seller. Staff admits that there are no assurances that the parties to the transaction could reach agreement to close around Washington. *Ex. 382.* Even if such an arrangement were possible, it seems unlikely that Washington ratepayers would be nearly as well served by QCI retaining the Dex operations for Washington alone, whether QC operated it as a standalone operation or entered into a publishing arrangement with a third party.

169 First, it is important to remember that there is no currently existing Qwest Dex standalone publishing business in Washington. If such a standalone business were to be created, a Qwest Dex Washington would face incredible challenges and would likely not approach a level of profitability realized today as a part of a region-wide business. On cross-examination, Mr. Burnett and Mr. Reynolds explained why that is so. QC would be required to start from scratch and very promptly get up and running in order to meet its regulatory obligations. At present, 26 different directories are published in Washington each year – a new directory every two weeks. In addition, QC would have to hire and reconstitute a work force, as it would not necessarily have access to the sales people who have cultivated the relationships with current Dex advertisers in Washington.[91] This process would be time and labor intensive and QC would lose significant economies of scale that are enjoyed under the current structure by running a region-wide directory business. Lastly, a standalone QC directory business for

[91] No party has suggested that the Commission has jurisdiction to approve or deny transfers of employees. Indeed, they are not property, and thus Chapter 80.12 is wholly inapplicable. In addition, to the extent that the employment relationship between Qwest Dex and its employees is an at-will employment relationship, no one can mandate that those employees work for any particular entity.

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Washington would likely face intense competition from existing competitors Verizon and Transwestern, other RBOCs and, perhaps most importantly, Dex Holdings. Dex Holdings will have up-and-running systems, experienced and well-connected employees and the advantage of operating in contiguous states. *Tr. 444-448, 450-451, 1148-1150.*

170 Under such circumstances, QC customers in Washington would likely receive far less support from a standalone Qwest Dex Washington operations than they would under the Settlement Agreement. They might even have to support that business through rates until it can reach profitability. Clearly, customers would be better off with the guaranteed and measurable benefits supported by Qwest, Public Counsel, AARP, WeBTEC and DOD in the Settlement Agreement. Assuming the Dex sale closed around Washington and QC opted (rather than operating a standalone directory business) to contract with a third party to publish Washington directories, there is absolutely no basis in the record to conclude that any company would offer QC anywhere close to $103.4 or $110 million per year for the privilege of publishing QC's Washington directories. As Mr. Burnett explained, Verizon, Transwestern and Dex Holdings – all facing the competitive tension of running retail and wholesale operations in contiguous locations – may or may not be interested in bidding to be QC's official publisher in Washington. *Id.* Staff speculated that a third party publisher would be willing to pay considerable royalties for the right to publish a QC directory (*Ex. 311, Selwyn, page 91*), but was unable to quantify those royalties (*Ex. 349*). Given the cost of paying QC for the right to publish on behalf of QC, and given the opportunity to successfully compete with a fledgling Qwest Dex Washington in QC territory, those entities may opt not to bid or to bid low for the right to publish for QC.[92] Under this scenario as well, QC ratepayers would likely be far better off with the guaranteed upfront payment and 15 years of benefits guaranteed under the Settlement Agreement.

[92] Indeed, Staff acknowledged that the fee another publisher would be willing to pay might well be less than current imputation. Tr. 946.

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B. Staff's Alternate Recommendation is Equally Unappealing, is Unlawful and is Contrary to the Public Interest

171 Staff also presents an alternate recommendation. If the Commission does not wish to deny the sale, the alternate recommendation would ostensibly permit the sale transaction to close. However, as discussed below, the financial conditions associated with this recommendation are so onerous that they simply amount to another recommendation to deny the sale, albeit one that is disguised as something different.

1. Staff's QCI-QC Contract Proposal Would be Counterproductive and Less Beneficial to Ratepayers than the Settlement

172 Staff's alternate proposal centers on a QCI-QC contract whereby QCI would annually make cash payments to QC for 50 years. *Ex. 370, at 24-25.* The contract would continue regardless of any other events, including a disassociation between QCI and QC or the end of rate of return regulation in Washington. Over the course of 50 years, QC would be paid in excess of $10.7 billion as "compensation" for the Washington share of the $7.05 billion sale price for the entire Dex operations. *Ex. 94, at 4.* Staff's proposal has no basis in fact and is potentially harmful to all parties involved for several reasons.

173 First, the contract amount is based on a gain calculation bearing no relationship to the sales price actually agreed to by Qwest and Dex Holdings in this arm's length transaction. Instead, Staff's proposal relies on the phantom gain discussed in section IV.B. above.

174 Second, Staff's recommended contract eviscerates the purpose of the Dex sale – to improve the companies' overall cash flow position and to pay down QCI, QSC and QC debt – by forcing QCI to make escalating annual cash payments to QC. As Mr. Reynolds explains, this new proposal presents Qwest with a Hobson's choice that is unworkable and unacceptable to the company. *Ex. 94, at 2-3.* It imposes on QCI, a company with severe cash flow constraints, a substantial new liability that will severely restrict the company's cash flow for the next 50 years. Further, Staff provides no guidance as to how these payments to QC are to be used or

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how the funds are to be held.

175 Third, Staff's contract proposal reflects Staff's lack of understanding of bankruptcy law. There was considerable discussion during the evidentiary hearing about various methods of distributing the gain on sale and about the effect of a subsequent bankruptcy on each such distribution method. Ironically, Staff's proposal represents the most vulnerable form of gain distribution suggested in this proceeding. As Mr. Mabey explained, executory contracts such as Staff's proposed QCI-QC contract can be rejected in bankruptcy. *Ex. 211, at 6.* When this occurs, the creditor's (here, QC) claim against the debtor is converted into a general unsecured claim. If Staff's contract proposal were adopted and QCI later filed bankruptcy, QC could be left standing in line with numerous other general unsecured creditors of QCI and would likely be paid little or nothing on its claim. In such an event, neither QC nor its ratepayers will receive any ongoing value from Staff's proposed method of distributing the gain. On the other hand, the revenue credit agreed to by the stipulating parties, if approved by the Commission in conjunction with a pre-bankruptcy Dex sale, would likely survive intact in the event QCI later files bankruptcy. This is because pre-bankruptcy Commission rate orders receive the highest level of deference from bankruptcy courts. *Tr. 718-720, 721-727.*

2. There is No Basis for a 10% Upfront Payment

176 Dr. Blackmon suggests that the Commission order QCI to make an upfront payment to ratepayers of 10% of the net proceeds from the Washington portion of the sale, but offers no rationale for why 10% (as opposed to 3%, 5% or 20%) is an appropriate level of compensation to *today's* ratepayers. *Ex. 370, at 25-26; Tr. 1387-1388.* Dr. Blackmon explains in vague terms only that the one-time payment is some form of penalty to compensate QC customers "for the additional risks that QCII has created for customers of QC." *Ex. 370, at 25-26.* However, this explanation provides no rational basis for the Commission to accept this arbitrary determination.

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3. The Proposed Limitations on QCI and QC Region-Wide Financing Activities and Management Prerogatives Proposed by Staff are Unlawful on Their Face

177 Finally, Staff urges the Commission, regardless of whether or not it adopts the QCI-QC contract proposal,[93] to impose three "additional safeguards to protect QC and its customers from ongoing financial risks of QCII's other enterprises." Those "safeguards" would restrict QC from increasing its debt-to-equity ratio above 48.32%, would restrict QC from increasing its dividend to QSC above 2002 levels and would restrict QC from lending or otherwise providing credit to QCI or any subsidiary[94] of QCI. *Ex. 370, at 26-26a.* As discussed in Section II. above, this Commission simply lacks the authority to impose these restrictions on QC, its affiliates and its subsidiaries, either as direct mandates or as conditions of approval.

VIII. FURTHER CONDITIONS ON THE SALE ARE NOT WARRANTED

178 During the hearings in this matter, other proposals with regard to disposing of the gain on sale were explored. These proposals included requiring a larger up front payment or credit to ratepayers or writing down the rate base instead of providing a revenue credit. As discussed below, the Commission should reject these alternative considerations.

A. <u>The Commission Should not Require a Larger Up Front Payment</u>

179 Although the Settling Parties agreed on an up front bill credit of $67 million, there were suggestions that the Commission should require a larger portion of the sale proceeds as an up front payment. *Ex. 370, at 25-26; Ex. 421, at 9.* Qwest has explained in its criticism of Staff's alternate proposal why a larger credit in the amount Staff recommends is not appropriate. Nor should the Commission consider any other type of a larger up front payment. Even Staff's witness Dr. Selwyn agreed that such a proposal had a number of problems, including whether

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[93] *Tr. 1389.*

[94] Dr. Blackmon's proposal actually seeks to restrict QC from lending cash or otherwise providing credit to "QCII or any <u>affiliate</u> of QCII other than QC." *Ex. 370, at 26a (underline added).* Qwest assumes Dr. Blackmon intended to use the term "subsidiary" given that QCI is the ultimate parent of all Qwest entities, and thus all related companies are subsidiaries (not affiliates) under Washington statute. *See* RCW 80.16.010.

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such a payment correctly identifies the customers who should be receiving the benefit.[95] Thus, the Commission should not consider increasing the $67 million credit.

B. <u>The Commission Should Not Order Qwest to Write Down its Rate Base</u>

180 During the hearings the idea of writing down Qwest's rate base as an alternative method of disposing of the gain was discussed. This concept was not proposed by any party in testimony, and was thus only developed through examination of various witnesses by the parties and the bench. The concept was criticized by Staff, Public Counsel and Qwest, thus creating greater consensus than heretofore seen in this proceeding. Several ideas were discussed, including a one-time rate base write down, an amortization of the rate base write down, and a stair stepping approach that would eliminate the write down in five-year increments over 15 years.

181 As Mr. Reynolds explained, Qwest opposes a rate base write down. A write down of $1.2 billion would first have to be adjusted to an after-tax number of approximately $750 million. *Tr. 1207-1208.* The resulting reduction in Qwest's intrastate revenue requirement would be between $85 million and $103 million annually, but the impact would continue in perpetuity, as a rate base write down would be permanent – once the rate base is reduced by $750 million, that amount would never be restored to the rate base. Thus, the adjustment has the effect of continuing imputation forever. *Tr. 1207, 1213.* As previously explained, perpetual imputation is contrary to the disposition of the asset and distribution of the gain.

182 Dr. Taylor echoed these concerns, and explained that depending upon future events such as cost of capital, the rate base write down could, in the future, have a much greater or a much smaller impact than originally contemplated. *Tr. 1215.*

183 As Dr. Blackmon explained, the process of writing down rate base is complicated. Although Staff looked very carefully at a reduction to rate base at the beginning of the proceeding, Staff

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[95] Dr. Selwyn testified on cross-examination that he does not believe that an upfront cash payment is necessarily a good idea because it "captures for today's rate payers in effect the Yellow Page imputation that tomorrow's rate payers, who may not be the same people, would otherwise have received." *Tr. 875.*

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ultimately did not (and does not) recommend that approach because of the difficulties associated with it. *Tr. 1477-1479.*

184 Mr. Brosch explained that one other major problem with writing down the rate base (with an amortization to ensure that the write down is not perpetual) is that it has a large up front rate impact, significantly reducing a company's revenue requirement, and thereby creating a likelihood of rate reductions in the event that a rate case occurs in the early years. However, that effect then diminishes as the years go by, creating incentives for Qwest to file one rate case after another to seek rate increases to capture the rate effect of that smaller amount. *Tr. 1304-1305.* He also explained practical problems with implementing a write down relative to the depreciation reserve, and with selecting which plant assets to write down. *Tr. 1305-1306.*

IX. CONCLUSION

185 Imputation was an interim solution to an affiliate transaction that the Commission found to be undertaken at an unacceptable level of compensation. It was never intended to be perpetual. The Commission and Supreme Court have recognized that imputation should end on the sale of the business, after an appropriate disposition of the gain. Staff's proposal that the Commission deny the sale is inconsistent with the public interest.

186 The Commission should approve the sale of Dex with the conditions set forth in the Settlement Agreement. The Settlement Agreement correctly recognizes that the sale of Dex is an essential component of Qwest's plan to delever its balance sheet and reduce debt. The sale, with the conditions agreed to by the Settling Parties is in the public interest. The Settlement Agreement fairly and appropriately balances ratepayer and shareholder interests.

DATED this 3rd day of July, 2003.

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