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

OPENING BRIEF OF COMMISSION STAFF

NON-CONFIDENTIAL VERSION

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I. INTRODUCTION

1 Qwest Communications International, Inc. ("QCII") proposes in this docket to sell its lucrative yellow pages business in its seven-state "Rodney" region to Dex Holdings, LLC.[1] The Commission should disapprove the sale. As the Commission has consistently ruled, and as upheld by the State Supreme Court, the yellow pages are a regulatory asset of the regulated telephone company, Qwest Corporation ("QC") the revenues of which are imputed to QC's revenue requirement for the benefit of the ratepayers. And as Mr. Kennard, speaking for the buyer, readily noted, the yellow pages business is a "quality asset" that a prudent RBOC would ordinarily never consider selling. Tr. 338. In fact, were it not for QCII's financially distressed situation in the summer of 2002, and the alleged risk of bankruptcy to QCII and QC, this case almost certainly would not be before the Commission today. Mr. Reynolds acknowledges this by referring to the "extraordinary circumstances that led Qwest to sell Dex." Ex. 64C at 10.

2 This is a crucial fact. For Qwest's case in support of the Dex sale hinges virtually entirely on its repeated, but remarkably unsupported claim that "without the sale, bankruptcy is likely." It is a sword that Qwest continually hangs over the

[1] The "Rodney region" comprises Washington, Oregon, Utah, Idaho, Montana, Wyoming, and Arizona. The "Dexter" portion of the sale, comprising the other seven states of Qwest's 14-state operating territory, closed in November 2002, at a sale price of $2.75 billion.

Commission's head. Without that sword, it becomes readily apparent that the Commission should disapprove the sale.

3 The Dex sale fails the test established by the State Supreme Court in *US West v. Washington Util. & Transp. Comm'n,* 136 Wn.2d 74, 949 P.2d 1337 (1997), which requires that fair value be paid to the regulated company, QC (not just to QCII). It also clearly fails the no-harm test set forth in the *Centralia Coal* case,[2] as customers will receive far fewer benefits as a result of the sale than they will under the status quo. This is true whether one calculates the benefits based on Qwest's position (providing for the "imputation" of non-existent directory revenues to QC for ten years), *see* Ex.64C at 18,[3] or those arising from the settlement agreement, *see* Ex**.** 2 (providing for a one-time bill credit $67 million, followed by "revenue credits" of non-existent directory revenues for fifteen years). In present value terms, QC and its customers can reasonably expect to receive **<CONFIDENTIAL: XXXXX END CONFIDENTIAL>** in benefits from the directory business during the 40-year term of the noncompetition agreement. Ex. 422C. Of the three customer benefit proposals made by Qwest in this proceeding, by far the most generous is the settlement, and yet even it, by contrast, provides only $874 million

[2] *In the Matter of the Application of Avista Corporation for Authority to Sell Its Interest in the Coal-Fired Centralia Power Plant,* et al., Docket Nos. UE-991255, UE-991262, and UE-991409, Second Supplemental Order; Order Approving Sale With Conditions, March 6, 2000. (*"Centralia Coal"*)

[3] Qwest's prior proposal provided imputation for 4.5 years. *Id.* and Ex. 61 at 19-21.

in present value benefits. It would leave ratepayers far short of what they are entitled, and what the Commission should require under its no-harm standard.

4 Nevertheless, Qwest insists, the Commission should look at this transaction as if it has but one choice: bite the bullet and approve the settlement. The threat of bankruptcy and its potential consequences is simply too dire, according to Qwest, to consider any other outcome. As Staff makes clear below, these predictions of doom simply do not withstand reasonable scrutiny. First, Qwest's pronouncements that QCII "likely" will file for bankruptcy if the Dex sale is disapproved in Washington are remarkably unsupported by any substantial evidence in the record. Although Mr. Mabey has offered expert testimony on the law and process that one follows in a bankruptcy proceeding, he specifically stated that he was *not* retained to advise QCII that it should make such a filing. None of the Qwest non-expert bankruptcy witnesses have presented anything resembling an analysis of any bankruptcy plans. In fact, the evidence confirms that Qwest has never discussed, considered, analyzed, or sought counsel regarding any actual bankruptcy scenario. Exs. 88, 91, 92; Ex. 211 at 3.

5 Second, even if QCII were to declare bankruptcy, there is no reason to believe either that Dex or QC would be sold separately in bankruptcy, or that a financially healthy QC would be forced into bankruptcy—the two horror scenarios that Qwest parades forth as harmful to ratepayers. The reason that Dex would likely *not* be sold is that creditors have a clear interest in maximizing the value of the yellow pages

business. As Dr. Selwyn demonstrates, that business derives its tremendous value from its longstanding and continued relationship with QC, the local telephone company. Ex. 311 at 55-97. The fact that QCII is attempting to sell Dex *outside* of bankruptcy, to help reduce QCII's high debt load and thus protect QCII shareholders (who could lose everything in a bankruptcy), does not mean that creditors would have a similar interest in ripping the yellow page operations from QC, which would permanently end the lucrative annual revenue stream it generates as well as greatly lessen its value.

6 As for the suggestion that a financially healthy RBOC such as QC might be forced into bankruptcy, Mr. Kennard, the former chairman of the FCC, said he found it remarkable that anyone could seriously countenance the bankruptcy of an RBOC. Tr. 311-312. Even if QCII somehow achieved such a remarkable result, the interests of customers and creditors would be closely aligned on the question of whether to sell Dex and QC separately or together, because both sets of interests benefit from having a healthy, financially viable telephone company emerge at the end of the bankruptcy; and this goal will be best met by keeping the yellow pages business with QC. To be sure, a bankruptcy would be painful to the QCII stockholders, but the Commission has no obligation to protect them from the consequences of the business decisions made by their chosen executives and board.

7 Moreover, even if bankruptcy were a possibility, there is no showing that approval of the Dex sale would improve QCII's long-term cash flow and financial

circumstances significantly enough to avert bankruptcy in the near future. Though the sale provides a short-term cash infusion, the evidence shows that even with the Dex sale, **HIGHLY CONFIDENTIAL XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXX END HIGHLY CONFIDENTIAL** Ex. 87(HC); Tr. 643-44.(HC).

8 The alternative bleak picture painted by Qwest—if rejection of the Dex sale in Washington does not throw the entire company to the bankruptcy wolves – is that Washington will become the directory ghetto, a stand-alone weakling to be preyed upon by rapacious directory publishers, including Dex Media itself. But this is equally unrealistic. The argument that other publishers would poach the Washington territory is supported only by speculation. As Dr. Selwyn and Dr. Blackmon made clear, QC could realize substantial benefits from a Washington-only directory business by partnering with another RBOC or contracting with an independent publisher such as RH Donnelly, and the result would be a valuable and viable business enterprise. Ex. 363TC at 12-13; Tr. 1470.

9 Stripped of the unsupported Qwest horror scenarios, the Commission is left with no persuasive reason to approve the Dex sale. The sale fails the no-harm test in *Centralia Coal*, and the sale also fails the test set forth by the State Supreme Court in *US West v. Washington Util. & Transp. Comm'n,* 134 Wn.2d 74, 949 P.2d 1337 (1997), for the simple reason that it does not provide fair value to QC, the regulated company, nor to its ratepayers. The fact that the sale will provide a short-term cash infusion to the

parent QCII (but may do little to improve QCII's long-term financial situation), and gives much of the gain to QCII and its stockholders, does not meet the fair value test demanded by the Court.

10 If the Commission concludes that it should nevertheless approve the sale, given the coercive circumstances presented by Qwest, then the Commission should capture all possible gains for customers and impose the safeguards recommended by Dr. Blackmon to prevent subsequent raids on QC's assets.

11 The Commission should not accept the terms of the settlement agreement because it is deficient in several respects. It rewards QCII where no reward is deserved, and it harms customers by giving them less than the full value of the asset. Accepting the transaction at the actual sales price, the Washington share is **CONDIFENTIAL XXXXXXXXXXXXXXXX XX> END CONFIDENTIAL** more than the value that customers receive in the settlement. In other words, roughly **CONFIDENTIAL <XXX XXXXX> END CONFIDENTIAL** of the value would fall to QCII and its stockholders if the settlement is approved. This is hardly the appropriate outcome when a company has, through its unregulated activities, risky ventures, accounting irregularities, and alleged corporate malfeasance, forced the state into the coercive approval of a transaction. Every dollar of the Washington gain amount should accrue to the benefit of customers, not only because customers deserve it but also because QCII does not deserve it.

12 The settlement is also wrong in the structure of the payments. The settlement permits QCII to harm QC, in that QCII gets all of the up-front money while QC has to make all the customer payments. Tr. 1269-70. The Commission should not accept this treatment, because it harms the public interest and it harms customers. QCII would leave QC a weak company, with resources well shy of its obligations. It should be QCII and not QC that is responsible for the compensation to customers.

13 The 15-years of "revenue credits" also may well prove to be illusory. Unlike the present imputed revenues, which are backed by real directory revenues earned by Qwest Dex, the revenue credits from QC would not be backed by anything. In other words, QC would simply receive from $103.4 million - $110 million less per year than it actually needs. Despite what QCII will say today about its willingness to live with this shortfall, the Commission should expect that QC will forego capital improvements in Washington, seek a higher rate of return due to higher capital costs, or take other actions detrimental to ratepayers.

14 If the Commission approves the Dex sale, then it should condition its approval on Qwest's acceptance of the conditions recommended by Dr. Blackmon to make it consistent with the public interest. *See* Ex. 370 at 24-26a; *see* section V(G) of this brief, *infra*. RCW 80.12.020 and RCW 80.01.040 provide that the Commission may disapprove the sale of public utility assets where the sale is not consistent with the public interest, and RCW 80.36.140 gives the Commission broad authority to regulate the practices of

telecommunications companies affecting rates. The recent practice, whereby QC is used by QCII as a source of creditworthiness and cash, is unjust and unreasonable. It has produced the result where a financially healthy public utility receives a junk bond rating, and borrows money it doesn't need at extraordinary interest rates. This practice causes direct harm to QC, by increasing its expenses and increasing its financial risk. The proposed sale of Dex, and the loss of the annual revenues it generates, significantly increases this harm. The Commission, if it approves the sale, should order that QCII cease this practice, which can be accomplished by imposing the conditions identified by Staff.

II. THE DEX SALE TRANSACTIONS

15 Qwest has agreed to sell its directory publishing business to Dex Holdings, LLC. The sale of the Dex business has been divided into two parts, "Dexter" and Rodney. The "Dexter" portion of the sale, comprising the other seven states of Qwest's 14-state operating territory, closed in November 2002, at a sale price of $2.75 billion. The "Rodney region" comprises Washington, Oregon, Utah, Idaho, Montana, Wyoming, and Arizona. The purchase price for Rodney is $4.3 billion.

16 The Purchase Agreement contains numerous other attached agreements. Of particular interest are (1) the 50-year Publishing Agreement, (Ex. 77) under which QC agrees to designate Dex as the "official publisher," and Dex Holdings agrees to perform QC's regulatory requirements regarding directory publishing; (2) the 40-year

Noncompetition Agreement, (Ex. 79) which restricts any Qwest affiliate from publishing, marketing, selling, or distributing any directory products, or entering into a joint venture, alliance, bundling arrangement, revenue sharing, or similar arrangement inside the Dex region with any alternative directory publisher, for a period of 40 years; and (3) the Expanded Use List License Agreement (Ex.1, Bates No. 000773-000794) which grants Dex Holdings a non-exclusive license to resell or provide services to third parties utilizing subscriber list information for direct marketing, database marketing, telemarketing, market analysis, and internal marketing.

17 The Publishing Agreement and Noncompetition Agreement each have a clause providing for liquidated damages of 30% of the purchase price in the event of breach. In addition the Purchase Agreement (paragraph 5.4(b)(ii), Bates No. 000598) states that the Qwest parties need not close the transaction if state public utility commission requirements collectively result in a "Material Regulatory Impact" (MRI) exceeding \$500 million.[4] An MRI includes an action that results in rate reductions, rate refunds, credits, one-time payments, or restrictions on the ability of Qwest to charge rates that it could have charged but for the Dex sale transaction.

18 The Dex sale transaction may be terminated by either the buyer or seller if the sale does not close by December 15, 2003. (Purchase Agreement, ¶ 8.1(g), Bates No. 000621.)

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[4] Although originally designated confidential, this is now a public dollar amount.

III. THE SETTLEMENT AGREEMENT

19 Immediately prior to the commencement of hearings in this matter, Qwest and Dex Holdings entered into a "Stipulation and Settlement Agreement" with Public Counsel, WeBTECH, AARP, and the Department of Defense ("DOD"), in which the parties stipulated to the Commission's jurisdiction, and recommended that the Commission approve the Rodney transaction subject to the terms of the settlement. Ex. 2. The parties allege that the settlement terms are in the public interest.

20 The settlement provides for a one-time bill credit of $67 million to be paid to "active customers of record," or $29.87 per access line. *Id.* at 3-5, ¶ 1 and App. 1. It also provides for an "annual revenue credit" to be added to Qwest's Washington intrastate regulated revenues of $110 million per year in years 2004-2007, and $103.4 million per year in years 2008-2018. These "revenue credits" would replace the current imputation of directory revenues to QC, and such imputation would cease. *Id.* at 5-6, ¶ 2.

21 Under the terms of the Merger Settlement Agreement in Docket UT-991358, Qwest has the right to file tariff revisions (which the Commission could reject) to remove customer-specific service quality remedies. The settlement here provides that while Qwest "commits not to petition" to remove those remedies through June 30, 2005, QC "may seek to change certain aspects of the Customer Service Guarantee Program during this period." *Id.* at 6, ¶ C-3. With regard to WTAP, the settlement provides that Qwest "commits" that its employees will be knowledgeable about the WTAP program

and benefits, and will accurately provide interested customers with necessary information. Qwest will develop an "action plan" and "work collaboratively" with other parties. *Id.* at 6-7, ¶ C-4.

22 Finally, the settlement states that "Qwest and WeBTEC will attempt to enter into a Memorandum of Understanding (MOU) on specific rate stability provisions," and that "Qwest and DOD will attempt to enter into an agreement on specific rate stability provisions." *Id.* at 7, ¶ C-5.

23 As set forth more fully below, Staff recommends that the settlement agreement be rejected. The one-time bill credit and 15 years of quasi-imputation "revenue credits" fall short of the Commission's "no-harm" test, because they provide ratepayers with far less than they can reasonably expect to receive in benefits from the yellow pages directory business. *See* Ex. 422C**.** The settlement also gives ratepayers far less than their share of the business enterprise value ("BEV") of the directory business, as demonstrated by Dr. Selwyn.

24 The remaining provisions of the settlement agreement (paragraphs C-3 through C-5) provide no material additional benefit and are unrelated to the subject at hand. While Staff does not necessarily oppose them, they do not provide any reason to approve the settlement. Ex 421C at 11.

IV. JURISDICTION

25 The Commission has jurisdiction to approve or reject Qwest's proposed sale of the Dex yellow pages directory business. This is made clear both in the Commission's statutes, as well as past dockets involving US West's partial transfer of the yellow pages operations. In *In re the Petition of US West Communications, Inc. for an Accounting Order,* Docket No. UT-980948, Fourteenth Supplemental Order; Order Denying Petition (July 27, 2000) ("*Accounting Order*"), at ¶¶ 164-165, the Commission stated:

> Chapter 80.12 RCW severely restricts public utilities' ability to transfer property without prior Commission approval. RCW 80.12.020 says, in part,
>
> > No public service company shall sell, lease, assign or otherwise dispose of the whole or any part of its . . . properties . . . without having secured from the commission an order authorizing it to do so.
>
> The consequence of failure to do this is made clear in RCW 80.12.030:
>
> > **Disposal without authorization void.** Any . . . sale, lease, assignment, or any other disposition, merger, consolidation, made without the authority of the commission shall be void.

26 In Docket No. UT-950200, (the US West Rate Case), the Commission held that the yellow pages publishing business was a regulatory asset of QC's predecessor, USWC. 169 PUR 4^{th} 417, 444 (Fifteenth Supplemental Order, April 11, 1996). US West had attempted to transfer this lucrative asset to a nonregulated affiliate in 1983 for inadequate compensation. In the *Accounting Order,* at ¶167, the Commission clarified

all that had been transferred were certain tangible assets of business. The Commission concluded:

> USWC has not receive authority to transfer the business asset. We find that for regulatory purposes any arrangement or disposition that purported to effect a transfer other than the limited transaction approved in 1983 is <u>void.</u> RCW 80.12.030.
>
> We conclude that USWC retains the asset, both by the factual history of the transaction and as a matter of law. We will continue to regulate USWC as though it retains all rights to the asset. . . . The Commission has continuing jurisdiction over any such arrangement, dating back to the original application.

Id. at ¶¶ 168-169 (underlining in original).

27 Qwest's petition for approval of the sale of the Washington portion of its yellow pages operations concerns a regulatory asset of QC, the regulated telephone company. It is subject to the Commission's approval or rejection under RCW 80.12.020.

V. ARGUMENT

A. The settlement agreement should be rejected because the Dex sale does not meet the State Supreme Court's requirement in *US West v. WUTC* that Qwest Corporation receive fair value for the asset. QCII's receipt of $7.05 billion, none of which goes to QC, does not meet this requirement.

28 In *US West v. WUTC*, 134 Wn.2d 74, 949 P.2d 1337 (1997), US West Communications, Inc. (the regulated telecommunications company and the predecessor of Qwest Corporation), petitioned the Commission for an end to the imputation of directory revenues for ratemaking purposes. The Commission denied the petition because USWC had failed to show that it received adequate compensation for the

partial transfer of the directory publishing business. The State Supreme Court affirmed the Commission's decision, and held that imputation could end, but only if *USWC* received fair value for the asset:

> US 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.

Id. at 102.

29 It is clear that the Court's reference to "US West" is a reference to *USWC* (QC's predecessor), and *not* US West, Inc. (the parent company, and effectively *QCII's* predecessor). *See id.* at 79. Indeed, US West, Inc. is mentioned nowhere in the opinion. Furthermore, the Court clearly understood that imputation was for the benefit of the USWC's ratepayers; and the Court clearly ruled that the directory publishing business could not be sold off, and imputation ended, until and unless USWC received fair compensation in return. *Id.* at 95-96, 102.

30 The proposed transaction and the settlement agreement before the Commission in this case do not provide fair value to QC, and must therefore be rejected. To the contrary, the sale of Dex that is ratified in the settlement benefits QCII and its shareholders. QCII receives $7.05 billion in upfront cash if the deal is approved. This money will be used to pay down some of the multi-billion dollar debt that QCII has amassed in recent years – debt that has arisen *not* because of any problems related to QC, the regulated company, but rather, virtually entirely because of the well-publicized difficulties of QCII's non-regulated companies.

31 QC does not receive the Washington share of the gain on this sale from QCII. Not only does QC not receive a penny of the sale proceeds, under the settlement, in fact, QC must make all the payments to customers, including the $67 million one-time bill credit. Tr. 1269-70. QC is also forced to accept from between $103.4 million and $110 million per year less than it actually needs, because the 15 years of "revenue credits" to ratepayers in the settlement are unfunded by QCII and are not backed by any actual revenues. (Whether QC's ratepayers will actually receive the full benefit of the revenue credits, if QCII's financial situation deteriorates in the future, is yet another question.) QCII would leave QC a weak company, with resources well shy of its obligations. It should be QCII, and not QC, that is responsible for the compensation to customers. The settlement agreement fails this test, and fails the requirement of *US West v. WUTC*.

B. The Commission's "no-harm" standard set forth in *Centralia Coal* requires that customers receive no less, under the proposed "Rodney" sale of the yellow pages directory business, than they currently receive through imputation of directory revenues. The settlement agreement falls far short of this standard.

32 The proposed sale of the Rodney directory business violates the first principle espoused by the Commission in *Centralia Coal* case:

> 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.

Centralia Coal, at 11, ¶ 29 and n.6. As Dr. Blackmon explains, customers of QC would be better off if QC did not participate in the Rodney transaction than if it participates as proposed in the settlement agreement (Ex. 370 at 3-4), because the sale would lead to higher rates and risk than would otherwise be the case. Qwest pointedly does *not* state that rates will not increase as a result of the Rodney transaction, but rather, only that the company is not proposing an increase at this time. Once the 15-year unfunded "revenue credits" expire – and quite possibly sooner, if QCII's situation continues to deteriorate -- rates will sharply increase. Dr. Selwyn aptly observes:

> The settlement would provide only the most limited benefit to ratepayers (the $67 million one-time bill credit) while exposing ratepayers to considerably higher rates in the future as well as an unfunded and possibly unenforceable "revenue credit" that is far less in amount, far shorter in duration, and far less certain than the existing imputation.

Ex. 363T at 7-8.

33 The net present value of future anticipated directory imputations – what QC and its customers will receive under the status quo – is **CONFIDENTIAL < XXXXXXX> END CONFIDENTIAL.** Ex 422C.[5] The settlement, by contrast, provides only $874 million of present value benefits, or a total shortfall of **CONFIDENTIAL XXXXXXX> END CONFIDENTIAL**. This is a massive disparity in benefits, one that no argument about future risk or appropriate discount rate can overcome. One can compare the two scenarios over any number of years using any discount rate, and the answers are consistent. In every year customers get more benefit from keeping the business than

[5] Dr. Selwyn calculates this amount to be **CONFIDENTIAL XXXXXXXXX>.** Ex. 311 at 45-46. Dr. Selwyn's calculations, set forth in detail in Ex. 325C, assume annual imputations reflective of the earnings and EBITDA assumptions that Qwest Dex management presented in the Offering Memorandum distributed to potential buyers.

they do with the proposed settlement. The only view that makes the settlement look even moderately favorable is one that considers only the up-front payment of $67 million, which customers would not receive if the transaction is rejected. A one-time payment of about $30 per line certainly has some value, but it is not worth the hundreds of millions of dollars of future benefits that customers would lose under the settlement.

34 Qwest and Dex Holdings both attack the merit of Staff's calculations, but their attacks are belied by their own persistent advocacy of the deal itself. They contend that Staff is being unrealistic in assuming that directory revenues will increase by 2.25% per year.[6] *See* Ex. 94 at 6. Yet that figure comes from their own management and was used by their own investment bankers. Ex. 325C; *see also* Ex. 371C. The audacity of the buyer and seller to criticize this figure when it lies at the heart of their own valuations is impressive, but it leaves the argument less than credible.

35 Qwest and Dex Holdings also attempt to attack the comparison between the settlement and the lost imputation benefits through what can only be described as an economist's sleight of hand. They claim that the status quo is highly risky and therefore must be discounted heavily, but simultaneously claim that the quasi-imputation "revenue credits" of the settlement are risk-free. The comparison is specious. Directory revenues are neither highly risky nor highly certain, which is why both the investment

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[6] The composite percentage is not confidential, although percentages for individual years are confidential.

bankers and Staff have applied a reasonable and consistent discount rate and escalation rate to all future values.

C. Even when measured against the Washington share of the gain, calculated by using the $7.05 billion Rodney sales price, the settlement agreement significantly fails the *Centralia Coal* "no-harm" standard.

36 Staff objects to using the $7.05 billion sales price as an accurate barometer of the BEV of the directory publishing business, as this clearly is a distress price that does not reflect the business' true value. However, for the sake of argument, Staff notes that even using this value as a measuring point, the Rodney sale fails the "no-harm" test. As set forth in Dr. Blackmon's Exhibit 371C, the Washington share of the gain amount is **CONFIDENTIAL XXXXXXXX> END CONFIDENTIAL.** The settlement, returning only $874 million, thus results in a shortfall to ratepayers of **CONFIDENTIAL <XXX XXXXXX> END CONFIDENTIAL.** The remaining amount is given to QCII and its stockholders. There is no principled basis for such a result.

1. The $7.05 billion sales price for the Dex directory business is a distress price that does not represent the fair value or the BEV of the business.

37 Qwest admits that its decision to sell the lucrative directory business was driven by QCII's precarious financial condition in 2002. Mr. Cummings stated that QCII needed to raise sufficient cash in time to meet heavy debt payments, at a time when QCII faced falling revenues and earnings and a debt load of over $25 billion. QCII's liquidity problems were exacerbated by the SEC probe into accounting irregularities relating to QCII's prior statements of its financial results. Exs. 172, at 8, 12,17. Mr.

Cummings added, "QCII had ever dwindling options to raise cash necessary to make upcoming required payments under the Amended Credit Facility in 2003." Ex 171 at 4.

38 As Dr. Selwyn points out, the QCII financial meltdown was heavily publicized and well-known to the financial community. Potential bidders were aware of QCII's rapidly worsening financial crisis, and would have factored the nature of the Dex sale into their offers. These circumstances created a buyer's market condition with respect to the Dex offering, and put QCII at a distinct disadvantage when trying to negotiate the highest possible price for Dex. Ex. 311 at 14-17.

39 The result was that the price QCII was able to negotiate with the eventual buyer, Dex Holdings, LLC, was approximately **CONFIDENTIAL XXXXXXXXXX END CONFIDENTIAL** than the mid-point of the range of BEV valuation estimates developed by Qwest's own financial advisors. These included valuations performed by Lehman Brothers and Merrill Lynch, as well as the investment banking firms of Bear Stearns, Credit Suisse First Boston, and J.P. Morgan. Dr. Selwyn describes these studies, and the consistent deviations between the distress sale price and the BEV valuation estimates contained in those studies, in detail. *Id.* at 12-38.

40 Moreover, during Qwest's work with its financial advisors for the Dex sale, Dex management provided the advisors with financial projections for the Dex business for the years 2002-2006. These are particularly significant because they represent the value that Dex's own management believed the Dex business to have just prior to the date that the sale transaction was agreed to. Dr. Selwyn prepared a discounted cash flow analysis of Dex based upon those financial projections, following the DCF analysis provided by Bear Stearns. This results in a total enterprise value for Dex of **CONFIDENTIAL XXXXXXXXXXXXXXXX XXX END CONFIDENTIAL** than the distress sale price of $7.05 billion. *Id.* at 35; Ex. 320C.

41 Mr. Kennard frankly acknowledged that:

> I don't think anyone would dispute the fact that at the time that Qwest was—decided to sell the Dex company that it was having –Qwest itself was having problems. That's one of the things that motivated the sale, but the asset itself is a very high quality asset.

Tr. 267. Later, in response to a question from Commissioner Hemstad, he stated that the "bottom line justification" for the sale being in the public interest was the risk of bankruptcy of QCII; and but for that, the Dex business was not an asset that a prudent RBOC would be selling. Tr. 338-39. Moreover, Mr. Kennard agreed, in response to questions from Chairwoman Showalter, that the financing market itself was volatile and the bond market was in a "lull period" at the time of the sale, and that these factors further constrained the sales price. Tr. 321-22.

42 The $7.05 billion price thus clearly falls short of the fair value, or BEV, of the Dex business. In determining the harm to ratepayers arising out of the settlement agreement, the appropriate measuring point is the difference between the up-front bill credit and "revenue credits" contained in the settlement, and the net present value of imputed directory revenues lost to ratepayers.

2. The settlement agreement is deficient because it provides unfunded revenue credits for only 15 years, while prohibiting QC from reentering the yellow pages directory business for 40 years. Ratepayers are thus unjustly deprived of 25 years' worth of imputation benefits lost.

43 A critical deficiency in the settlement agreement is that it fails to provide ratepayers any compensation for the imputed directory revenues they will lose after the passage of fifteen years. The Rodney sale agreement is expressly conditioned on the inclusion of a 50-year publishing agreement (Ex. 77) and a 40-year noncompetition agreement (Ex. 79). Under the former agreement, QC is required to designate Dex Holdings, LLC as its "official publisher" for 50 years, while Dex Holdings is required to fulfill all QC's publishing requirements. Under the latter agreement, QC is prohibited from reentering the directory publishing business for 40 years. Absent the sale, ratepayers would receive the benefit of continued directory imputations during this time. Now, however, they are required to forfeit these benefits from years 16-40, in return for nothing.

44 Qwest and Dex Holdings continually try to have it both ways on this point. They argue that the mismatch between the 15-year settlement and the 40-year noncompetition agreement should be of no concern to the Commission. Yet both the publishing and noncompetition agreements were an imperative for the buyer and seller. They were so important, in fact, that should QC breach either of these agreements, it is obligated to pay Dex Holdings a 30% liquidated damages penalty. Ex. 74, ¶ 5.4(b)(iii). A breach covering the entire Dex service area would cost QC over $2.1 billion. This penalty was not designed to remedy merely a theoretical or "remote" possibility that QC might breach the noncompetition or publishing agreements, even though Mr. Kennard at one point attempted to downplay the value of the liquidated damages clause in this manner. See Tr. 289. To the contrary, the FAS 141 Report attached as an exhibit to Mr. Kennard's testimony assessed the probability of a material breach in some or all of the Dex operating areas at 50%. Ex. 243, p. 20.

45 In fact, the 40-year noncompetition agreement was deemed to be critical to the buyer. Mr. Kennard stated that it was "a necessary component of the overall transaction," a negotiated and bargained-for provision in the sales agreement that addressed specific business concerns of Dex Holdings. Tr. 314. Those concerns would *not* have been met by a shorter noncompetition provision, such as five to ten years. Tr. 316. Moreover, Mr. Kennard added:

> At this point, if those agreements were to changed in really any substantial way but certainly one that would reduce the term, I think it would jeopardize the financeability of the transaction.

Tr. 315. This confirms the paramount significance of the 40-year noncompetition term to Dex Holdings. The foregone benefits it represents for QC and its ratepayers is of equally great significance, and cannot simply be shunted aside. The settlement, however, by affording ratepayers nothing after 15 years, does precisely that.

3. The settlement agreement improperly gives a substantial amount of the benefit of the Dex sale to QCII and its shareholders. Ratepayers are entitled to 100% of the benefit of the sale, under the principles of the *Democratic Central Committee* case, and under the findings of this Commission and the State Supreme Court.

46 The settlement agreement effectively rewards QCII and its shareholders by giving them a substantial share of the gain on sale. Assuming that the Dex transaction is valued at the actual sales price, they will receive **CONFIDENTIAL XXXXXXXXX END CONFIDENTIAL** if the settlement is approved, or nearly one-fourth of the Washington portion of the gain on sale. *See* Ex. 422C. There is no justification for this result. Ratepayers are entitled to receive 100% of the benefit of the sale, as they have borne the risk of loss on the asset.

47 The landmark case of *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Transit Commission,* 485 F.2d. 786 (D.C. Cir. 1973, *cert. denied,* 415 U.S. 935 (1974), established the principle that "the right to capital gains on utility assets is tied to the risk of capital losses" and that "he who bears the financial burden of a particular utility activity should also reap the benefit resulting therefrom." As the court further explained, the traditional ratemaking "practice in the utility field has long imposed upon consumers substantial risks of loss and financial burden associated with the assets employed in the utility's business." *Id.* at 806.

48 This is clearly the case with respect to Qwest's regulated operations in Washington, including the yellow pages directory business. Qwest witness Mr. Grate's

contentions to the contrary-- that shareholders have borne the risks of loss and are thus entitled to the gain on sale -- are directly rebutted by the findings of the State Supreme Court in *US West v. Wash Util. & Transp. Comm'n,* 134 Wn.2d 74, 949 P.2d 1337 (1997). The Court first noted the historic linkage of the directory business with US West's regulated operations, and found that its benefits did not derive from entrepreneurial risks taken by shareholders:

> The record shows that US West did not develop this lucrative business by its initiative, skill, investment, or risk taking in a competitive market. Rather, it did so because it was the sole provider of local telephone service, and as such owned the underlying customer databases and had established business relationships with virtually all of the potential advertisers in the yellow pages. Therefore, the Commission reasonably concluded that the yellow pages business is quite unlike businesses of other unregulated companies which were developed in, or derive their profitability from, the competitive marketplace.

Id. at 99. Then, the Court cited favorably to the Colorado Supreme Court's rejection of the argument by another Qwest predecessor, Mountain Bell, which had contended that "the publishing assets belong to its shareholders who took the risks to develop the publishing business." The Court disagreed, finding, "It is an exaggeration to say that Mountain Bell's shareholders took any significant risk in developing the publishing business, and we find the public interest in those assets to be beyond dispute." *Id.* at 101, *citing Mountain States Tel. & Tel. Co. v. Public Util. Comm'n,* 763 P.2d 1020, 1027-28 (Colo. 1988). The same is true of the Washington Dex business.

49 Furthermore, this Commission has consistently characterized the directory publishing business as an "asset" and a "regulatory asset" of the regulated telephone company. The Commission has held, moreover, that except for the transfer of certain tangible assets transferred in 1984, the regulated company retains the directory publishing business. *See US West Rate Case Order,* Docket No. UT-950200 (Fifteenth Supplemental Order, April 11, 1996), 169 PUR 4th 417, 444 (1996) ("The Commission finds the directory publishing business to be a regulatory asset"); *Accounting Order,* Docket UT-980948, at¶ 169 ("We conclude that USWC retains the asset [the directory publishing business], both by the factual history of the transaction and as a matter of law.") It has consistently been treated, for regulatory purposes, as an integrated part of the regulated telephone company.

50 Mr. Grate's argument that shareholders have somehow borne the risks and burdens of the directory publishing business is flawed in numerous respects. Most notably, as revealed by Commissioner Hemstad's questions during the hearing, it is a one-way "analysis" under which only the QCII shareholders can win. Mr. Grate contends, "Consequently after 1917, ratepayers never had to bear the financial burden of the company's directory expenses." Ex. 101, p. 12. In response to whether this was an assertion of theory or fact, he said, "It was an assertion of fact, which was that as it happened, rate payers never did have to bear the expenses, because they were in excess." Tr. 504. Commissioner Hemstad continued:

> Q. And, of course, that's the benefit of hindsight. But you are not asserting, are you, that that's how one looks at the issue of risk reward and benefit burden?
>
> A. I am asserting that, yes. I am asserting that whether rate payers have borne the burden is a question of fact.

Id. According to Mr. Grate, ratepayers can only lose: they bear the burden of loss only if they can show, with 20/20 hindsight, an actual loss in operating revenues. If, armed with such hindsight, there is no such loss, then Mr. Grate concludes that the shareholders "bore" all the burden and they get all the gains. It is easy to see why Qwest would want the Commission to apply such a skewed "analysis," given the fact that we now know that the directory publishing business has been lucrative indeed: the Commission found that its Washington operations earned a 229% rate of return in 1994, and that the overall business exceeded 150% for every year from 1989-1995. *US Rate Case Order*, 169 PUR 4th at 448. But this 20/20 hindsight approach is not what the law entails.

51 Mr. Grate also contends that the history of the directory business should be "carved up" into three periods: pre-1923, 1923-1984, and 1984 to the present. As Dr. Selwyn points out, this argument fails on many counts. First, the pre-regulatory period is irrelevant; whatever risks were attendant to the directory publishing business before the establishment of the ILEC's regulatory rate base were captured when it came under regulation. Second, Mr. Grate's analysis appears to assume that whatever risks ratepayers might have undertaken arise exclusively from their obligation to maintain

physical, depreciable assets. In fact, *Democratic Central Committee* requires one to look at the business enterprise in a holistic manner, encompassing both tangible and intangible assets. Ex. 311 at 63-64.

52 Third, the 1984 transfer of certain assets from USWC to an unregulated affiliate did not fundamentally change ratepayers' interests and obligations with respect to the directory publishing business. The Commission's *Accounting Order* made clear that "the yellow pages publishing activity has not been transferred permanently to USWC's affiliate for regulatory purposes," and more specifically, that the intangible assets associated with directory publishing business were not so transferred. *Id.* at ¶¶ 19, 163-64, 168. This decision preserved the interests of QC and its ratepayers in the intangible assets that represent the core value of the directory publishing business. Ex. 311 at 65-67.

53 Most of these assets included in the Dex sale are not simply "goodwill," as Mr. Grate has attempted to characterize them. Rather, they are separately identifiable, intangible assets that derive their value from QC 's and USWC's position as the legacy *de facto* monopoly provider of basic local exchange telephone service. Dr. Selwyn's Ex. 326HC contains a list of QC- transferred assets included in the Dex sale. The items conveying the most value are included in the Purchase Agreement as separate exhibits, and include the 50-year Publishing Agreement, the 40-year Noncompetition Agreement, and the Expanded Use List License Agreement. These first two agreements

were so significant, in fact, that the Publishing Agreement provided, in section 6.4(a) (Bates No. 000729):

> Publisher would not have entered into the LLC Purchase Agreement [Dexter] and the LLC II Purchase Agreement [Rodney], if QC had not simultaneously agreed to be bound by this Agreement and the Non-Competition Agreement and that QC's performance in this Agreement and the Non-Competition Agreement form a significant part of the benefit that Publisher intends to realize in entering into the LLC Purchase Agreement and the LLC II Purchase Agreement.

54 Mr. Kennard attempted to devalue the significance of these critical agreements, which were also backed by a 30% liquidated damages penalty, through reference to some of the findings in the FAS 141 study attached to his testimony. He later acknowledged on cross-examination, however, that the FAS 141 study is prepared by the buyer solely for financial reporting, accounting, and taxation purposes. Tr. 285-86. And, as Dr. Selwyn explained, they do not address the value that is being contributed by QC to the transaction. Tr. 1012-1014.

55 The Commission, in the *Accounting Order* and in past orders addressing the partial transfer of the directory publishing business to Dex, has repeatedly ordered that ratepayers receive the full value of the rights granted to Dex in the various publishing and other agreement. *See* Ex. 311 at 79-81. Qwest Dex also has franchise value, separate from goodwill, which does not derive from stellar customer service or exceptional qualifications, but rather from its legacy market position and first-mover advantage that is tied directly to its long *de facto* monopoly. *Id.* at 84-90.

56 Only a small amount of actual "goodwill," consisting mainly of the Dex workforce, is being sold to the buyer. The costs associated with ongoing maintenance of the workforce were simply expensed on the Dex accounts. As a result, any additional costs increased the expenses of Dex, and therefore, the amount imputed to ratepayers. Under *Democratic Central Committee*, the gain attributable to this workforce should therefore be attributed to QC, and to the ratepayers. *Id.* at 96.

57 In sum, all of the Washington gain on sale is attributable to the ratepayers. The settlement agreement, without justification, instead allocates nearly **CONFIDENTIAL <XXXXXXX> END CONFIDENTIAL** of that gain to QCII and its shareholders, and should be rejected.

4. *Centralia Coal* does not require the Commission to reward QCII and its shareholders by giving them any portion of the gain.

58 Mr. Reynolds suggests that *Centralia Coal* requires the Commission to provide part of the gain to QCII and its shareholders, as part of a "balancing" of QCII and QC ratepayer interests. *See* Ex. 64C at 20. This suggestion is plainly incorrect. First, *Centralia Coal* made clear that each case must be dealt with based on its specific circumstances. Docket UE-991255, Second Supplemental Order, at ¶ 29. It did not set an immutable principle that shareholders are entitled to share in the proceeds of a gain on sale of a regulatory asset developed as a result of QC's *de facto* monopoly telephone franchise, and where shareholders have not borne the risk of loss or the financial burdens related to that asset. It certainly does not require that QCII be rewarded for its

poor financial condition that has led it to attempt to sell the directory business. *Centralia Coal* dealt with facts entirely different from those presented here.

5. Qwest's calculation of the gain on sale improperly deprives ratepayers of revenues derived from secondary directories, non-Qwest primary listings, and Dex's New Ventures/Internet operations.

59 Dr. Blackmon's Exhibit 371C (GB-2C) calculates the Washington portion of the gain on sale **(CONFIDENTIAL XXXXXX> END CONFIDENTIAL),** which the settlement agreement fails to provide to ratepayers. The Washington portion is calculated by using an earnings-based allocator of **CONFIDENTIAL <XXXXXXX.** As Dr. Selwyn explains, this compensates Washington ratepayers for revenues derived from Qwest's primary directories, as well as revenues derived from secondary directories, non-Qwest primary listings, and Dex's New Ventures/Internet operations. Qwest's use of an allocator of **CONFIDENTIAL <XXXXXXX** deprives ratepayers of these revenues, and should be rejected. Ex. 311 at 107-08.

60 Qwest currently publishes two directories in Washington that it classifies as secondary, the Greater Snohomish County Directory and the Greater Puget Sound One-the-Go directory. The non-Qwest listings in its primary directories are mostly listings of other ILECs' telephone service subscribers, with about 10% being listings of CLEC customers. Ex. 311 at 99. Qwest is obligated by Secs. 251(b)(3) and 271(c)(2)(B)(viii) of the Telecommunications Act of 1996 to provide such listings for CLEC customers.

61 Qwest's position essentially amounts to an attempt to take a snapshot of the Dex directory publication at a single moment in time (January 1, 1984, the date of the purported transfer of the directory publishing business from PNB to Dex's predecessor, US West Direct) and limit the Commission's consideration of the business to only those operations that were occurring at that time, over nineteen years ago. As Dr. Selwyn states, like any ongoing business, the Dex operation has changed over time in many respects, including changes in directory advertising subscribership, advertising rates, number and scope of directories, directory circulation, and other factors. However, Qwest not advanced any sound economic reason why a subset of those changes (secondary listings and non-Qwest primary listings after 1984) should qualify for different treatment than any other changes in the business over time. Qwest has provided no basis for believing that, had the directory publishing activity remained within the QC entity throughout this period, the publication of secondary directories or non-Qwest primary listings would not itself have been undertaken by the QC directory publishing operation, rather than by the affiliate. Ex. 311 at 100.

62 Dex's publication of secondary directories and non-Qwest primary listings are financed from the same sources as the rest of Dex's business operations. QC integrates subscriber list information (SLI) of other providers into its SLI and transmits that information to Dex, without differentiating it from its own in any way. Dex uses the same brand identification and marks on its primary directories as it does on its

secondary directories. The same sales and support organizations are involved in both of these activities. Dr. Selwyn describes in further detail the numerous reasons why there is no basis to differentiate secondary listings, primary listings, or New Venture/Internet operations. *Id.* at 101-105.

63 Finally, as Dr. Selwyn notes, the Commission's prior imputations have never recognized less than the entirety of the directory business. The Commission previously has found that "the public interest requires that the full reasonable value of the directory publishing enterprise be deemed available to PNB for ratemaking purposes." Docket U-86-156, Second Supplemental Order, at 10 (October 11, 1988). Today, the full reasonable value of the directory publishing enterprise includes all aspects of Dex's current operations. Staff's allocator of **CONFIDENTIAL <XXXXXX END CONFIDENTIAL** properly reflects this value.

D. The Commission should not approve the Dex sale based on Qwest's unsubstantiated statements that "bankruptcy is likely" without the sale.

64 As the Commission reviews the proposed Dex sale and settlement agreement, it must keep in mind that the *only* factor that could possibly justify approving the settlement is Qwest's repeated refrain that without the sale, "bankruptcy is likely." In a very real sense, Qwest is threatening harm to ratepayers if the sale does not occur, stating that this event will "likely" start a chain reaction: QCII files bankruptcy, takes the healthy and profitable QC with it, and then separately sells off Dex, after which ratepayers will get nothing, and the Commission will not be able to stop them from

doing it. That is what is threatened here. Without this threat, the settlement agreement should clearly be disapproved, since it deprives ratepayers of substantial benefits to which they clearly are entitled.

65 The Commission should not give credence to Qwest's threatened bankruptcy scenarios, for many reasons: (a) Qwest's claim that it will file bankruptcy is remarkably unsubstantiated; (b) even if QCII did file bankruptcy, there is no reason to believe, from an economic and business standpoint, either that QC would be included in the bankruptcy or that creditors would desire to separately sell Dex; (c) even if the bankruptcy threat is real because of QCII's significant financial and other problems, (1) the Dex sale may well be only a short-term band-aid that does not address those problems or avert a bankruptcy a few years from now, and (2) the unfunded "revenue credits" proposed in the settlement may prove to be of no real benefit at all to ratepayers of a QC that needs more dollars than it has or can obtain from its parent. If the Commission nevertheless decides to approve the settlement agreement, then it should make the monetary adjustments and structural safeguards proposed by Staff to ensure that ratepayers of QC are not threatened by QCII in the future.

1. Qwest's statement that "bankruptcy is likely" is unsupported by the record.

66 Qwest witness Mr. Reynolds states, "Without the entire sale, bankruptcy is likely." Ex. 61 at 9. He further appears to contend that the "extraordinary

circumstances which led Qwest to sell Dex" essentially forces the Commission to approve the settlement agreement, regardless of the deficiencies it contains.

67 Yet if one reviews the record in this case, actual evidence supporting Qwest's bold claim is strikingly absent. Mr. Reynolds stated that he had no personal knowledge of any bankruptcy plans on the part of QCII. Tr. 1020. In fact, his testimony in this matter is based entirely on that of Mr. Mabey and Mr. Cummings. Tr. 1050. But Mr. Mabey expressly stated that he was *not* retained by Qwest as bankruptcy counsel for QCII or any of its subsidiaries, and had not been retained to advise on "whether, when, or how to file bankruptcy or to protect themselves from creditors." Ex. 211 at 3. He added on cross-examination that his knowledge of any bankruptcy plans on the part of QCII and its subsidiaries was limited to what he heard during the hearing. Tr. 696.

68 In fact, despite Qwest's contention that bankruptcy is likely, it has made no plans or preparations for this contingency. The directors of QCII have taken no formal action to recognize that bankruptcy is imminent. Tr. 1055. Qwest answered in response to Staff's data requests that it has no documents comparing or considering the sale of Dex as an alternative to the filing of a bankruptcy petition by QCII or its subsidiaries. Ex. 92. It has no documents pertaining to the effect of bankruptcy on the operations and financial structure of QCII or its subsidiaries. Ex. 91. Nor do any of the business plans or other documents which analyze the financial condition of QCII, assuming that Dex is not sold, reference bankruptcy. See Ex. 88. Moreover, as Dr. Blackmon noted, at a

financial conference in March 2003, Qwest's chief financial officer spoke for almost an hour and never referenced bankruptcy, and last fall (when QCII's financial situation was worse than it is now) the CEO was widely quoted as saying that "the B word" has not been spoken in his presence by company executives. Ex. 370 at 11. Last fall, when Qwest's days were allegedly darkest, it certified in section 4.2 of the ARCA to its present and future solvency. Tr. 558.

69 Mr. Cummings contended that Qwest's agreement to sell Dex was critical to the successful renegotiation of the amended and revised credit agreement (ARCA), and that absent the ARCA, Qwest would have faced bankruptcy in 2002. Ex. 178 at 3 and 15. But he admitted that failure to complete either the Dexter or Rodney portion of the Dex sale is not an event of default under the ARCA. Tr. 555-56.

70 Moreover, the findings of the credit rating agencies do not support Qwest's position. Moody's has concluded that the sale of Dex is not significant one way or the other in terms of Qwest and its bond ratings. Moody's has Qwest's ratings on review for a possible downgrade, and lists four conditions that must be met before it can take Qwest off the list of suspect companies. The sale of the Dex business is not one of those four conditions. Ex. 425; Tr. 1492. And while Standard & Poors has stated that the Dex sale is necessary to meet the schedule of debt repayment currently in place, they do not

state that that schedule cannot be renegotiated or the debt refinanced, or that bankruptcy will occur without the sale.[7] Ex. 420; Tr. 1492.

71 In any event, the evidence clearly shows that the financial situation both of Qwest, and the economy in general, are better now than they were in 2002. As Mr. Reynolds acknowledged, "I think that the economic conditions are more favorable today than they were then [i.e. in August 2002], so things look brighter for the company." Tr. 1052. Qwest's stock price has increased significantly since the spring/summer of 2002 (from about $1.07 to $4.70), and this increase is not simply a product of Qwest's announcement that it intended to sell Dex. The overall market has greatly increased in value, and "the rising tide does float all of the boats, and so Qwest did get some help from the stock market trends in general." Tr. 565; *see* Tr. 1053. Qwest's stock also has benefited from the removal of Joe Nacchio as the company's CEO and his replacement by Richard Notebaert, which Mr. Cummings described as "a positive influence on the company." Tr. 566.

72 Qwest would have the Commission believe that the plan to sell Dex has caused its borrowing costs to decline. It cites a decline in the credit spreads of 228 to 348 basis points for QC between the third quarter of 2002 and the first quarter of 2003. Ex. 178 at 11. This proposition is clearly in error; the change in credit spread for all B-rated

[7] On June 9, 2003, Qwest announced that it had refinanced $1 billion of debt issued to QC, which had been due in June 2003. The new loan amount has been increased to $1.75 billion, which Qwest states is due to "increased lender demand." Ex. 20, at 2.

corporate bonds over roughly the same period (September 2002 to May 2003) is even greater, about 400 basis points. Ex. 205; Tr. 563-64. Qwest actually has enjoyed a smaller decline in borrowing costs than its peers while the Dex sale has been pending. The credit spread evidence shows exactly the opposite of what Qwest claims.

73 All of this militates against Mr. Reynolds' statement that bankruptcy is likely without the Dex sale. But perhaps even more importantly, as Dr. Blackmon points out, bankruptcy is *not* a choice that QCII could ever make lightly. QCII attempts to use the bankruptcy scenario to win approval of the Dex sale, but it actually is the one that fears bankruptcy. For QCII knows that in a bankruptcy, its common stockholders will be the big losers – "they get wiped out altogether." Tr. 1468. And QCII's biggest stockholders will be the biggest losers of all. QCII's principal shareholder, Philip Anschutz, for example, stands to lose about $1.1 billion (at a stock price of $4.00 per share), four times the amount that Qwest's employee-shareholders would lose. Ex. 370 at 15. Stockholder losses are not necessarily contrary to the public interest; indeed, this is exactly what should happen when the management and directors of a company, for whom the common stockholders are ultimately responsible, dissipate the value of the company. But the prospect of such losses is certainly a key reason why QCII would strive mightily to avoid any bankruptcy filing.

74 Staff has reviewed Qwest's claim of likely bankruptcy very closely – much more closely, we believe, than have the other parties to this case. Staff has not taken this

claim lightly. But Qwest's claim of imminent bankruptcy – particularly now, rather than in the summer of 2002 – appears driven by speculation. The Commission should not approve the Dex sale or the settlement agreement on the basis of a speculative threat.

2. Even if QCII did file for bankruptcy, there is no basis to presume that QC would be brought into the bankruptcy, or that the Dex directory business would be sold separately.

75 The next question is what happens if QCII were to file for bankruptcy? Since Qwest has no documents or business plans concerning such a filing, what happens next is perhaps even more speculative. Mr. Mabey states that "anything can happen" in a bankruptcy. Ex. 211 at 18. Mr. Mabey also sets forth, in primer style, the various steps that QCII or its creditors *legally* might take in a bankruptcy proceeding. But even if those legal pronouncements are correct – and that is not a certainty, given that the *Pacific Gas & Electric*[8] case is currently on appeal to the Ninth Circuit, and its facts are significantly different from ours – the question here is what *would* the creditors likely do if QCII declares bankruptcy? They would do what is in their economic best interest. And Staff has shown that this likely would not entail either the inclusion of a healthy QC in a bankruptcy proceeding, or a separate sale of Dex.

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[8] Ex. 201, *In re Pacific Gas and Electric Co.,* 283 B.R. 41 (N.D. Cal. Aug 30, 2002), *appeal docketed,* No. 02-16990 (9th Cir. argued May 14, 2003).

76 Qwest contends that if QCII goes into bankruptcy, the Commission's authority over the sale of Dex, and over QC and its rates, will be compromised. This contention is based on federal bankruptcy law, including the United States District Court opinion in *Pacific Gas & Electric*. That case is currently on appeal in the Ninth Circuit, and oral argument was held on May 14, 2003. The Court of Appeals' decision may determine the extent to which state commission action is preempted by the bankruptcy code. But the Commission should still keep in mind that the facts of *Pacific Gas & Electric* are quite different from those in this case. There, the court is faced with a highly troubled regulated public utility company that is seeking to reorganize its lines of business. Here, QCII, the parent company, has experienced financial difficulties due to the risky ventures and accounting irregularities of its unregulated affiliates, while QC, the regulated company remains steady and profitable. The fact that the court might uphold the restructuring of troubled PG&E does not mean that a bankruptcy court would allow QCII to bleed to death its financially healthy regulated telephone company over the objections of the state commission.

77 Assuming it could, why would QCII bring QC into bankruptcy? Mr. Mabey offers two reasons. First, "A company need not be insolvent to file bankruptcy. A troubled company may seek to reorganize under the bankruptcy laws without waiting until its circumstances are hopeless." Ex. 211 at 3. That certainly does not describe QC. Second, "to facilitate the proposed sale of Dex." *Id.* at 9. But this assertion requires Mr.

Mabey to make the assumption that it would be in the creditors' interests to do this. The evidence suggests otherwise.

78 Mr. Kennard stated that a financially healthy QCII would never sell Dex. "That's why you don't see Verizon or BellSouth or SBC selling their yellow page businesses." Tr. 338-39. Mr. Mabey stated that the directors of the bankruptcy estate have a duty to maximize its value for the benefit of creditors, Tr. 701, and that the objective of a reorganization bankruptcy is to have the company emerge as a viable company. Tr. 698. As has been explained in detail above, Dex is a lucrative enterprise because of its longstanding association with QC, the regulated telecommunications company.

79 Putting these pieces of information together, Dr. Blackmon correctly noted that, were a QCII bankruptcy to occur, creditors would look at companies such as Verizon, BellSouth and SBC, and would conclude that they need to structure a company that looks like those – one that has a directory publishing operation as a stable, strong source of revenue. Even though Qwest now seeks to sell Dex outside of bankruptcy, it simply does follow that creditors, who would not be constrained by the levels of debt and repayment schedules that Qwest now faces, would choose to do the same. They likely would not. Tr. 1467-68.

80 In other words, the interests of ratepayers and creditors would likely be aligned in a bankruptcy proceeding. Both will benefit from having a healthy, fully functional, viable telephone company emerge, together with its directory operations. Qwest's

speculation that ratepayers will lose all of their interests in a bankruptcy – through a Dex sale that would disburse the asset and preclude any further imputation – is not supported by the evidence.

81 Mr. Kennard also stated that he found it "frankly remarkable that anyone would seriously countenance the bankruptcy of an RBOC[.]" Tr. 311-12. Given this, it simply is not credible to suggest, as Qwest has, that QCII will have complete discretion to push QC into bankruptcy simply because that would provide QCII's stockholders with the largest financial return. Pushing a subsidiary into bankruptcy may well be allowed under the bankruptcy statutes, by there are other considerations when the subsidiary carries the public interest responsibilities of an RBOC. The FCC, state regulators, and Congress would likely bring a great deal of pressure on QCII not to include QC in the bankruptcy filing, and this would be particularly true given the healthy and stable financial condition of the RBOC entity. It is, as Mr. Kennard said, remarkable to suggest that QCII would seriously countenance the bankruptcy of QC in the circumstances presented here.

3. Even if QCII's current financial situation would make a bankruptcy likely without the Dex sale, Qwest has failed to show that QCII will not be in this same position in the near future.

82 Qwest's bankruptcy scenario is also a two-edged sword. Assuming that QCII's current financial situation is, indeed, so dire that the Dex sale is needed to avert bankruptcy, Qwest has wholly failed to show that QCII will not be in this same position

a few years hence, except that then, it will have been stripped entirely of the lucrative yellow pages business.

83 Dr. Blackmon emphasized this fact. The short-run effect of a Dex sale is to provide QCII a one-time increase in cash flow. However, on an ongoing basis, it does not improve cash flow or profitability, or improve the company's long-term prospects as a business enterprise. To the contrary, it loses a large, stable, and growing profit center, and the Dex sale may serve only to postpone a QCII bankruptcy. This is further corroborated by Qwest's own studies, which show that even with the Dex sale, **HIGHLY CONFIDENTIAL < XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXX> END HIGHLY CONFIDENTIAL** Ex. 87(HC). Tr. 643-44 (HC).

84 This, in turn, renders the 15-years of unfunded revenue credits under the settlement agreement quite problematic for QC's ratepayers. Contrary to the suggestion of Mr. Brosch, this will likely not put an end to an historically contentious issue. If QCII's situation is as dire as Qwest suggests, then Qwest has failed to explain how QC will be able to continually accept between $103.4 and $110 million less in revenues than it actually needs, year after year. Instead, QC will likely soon be back before the Commission contending that it should not be forced to remain in such an untenable position. Tr. 1488-89.

E. Even if QCII were to file for bankruptcy, the result may not be detrimental for QC or QC ratepayers.

85 Qwest argues that the Commission should approve the Dex sale because otherwise, QCII will "likely" file for bankruptcy. Assuming solely for the purpose of argument that this were to happen, the result might not be detrimental for QC or QC ratepayers. Recent history, in fact, contradicts Qwest's dire predictions.

86 First of all, as Ms. Folsom sets forth in detail, the bankruptcy of Enron has not had dire effects on its subsidiary, Portland General Electric (PGE). Enron recently experienced one of the largest and most spectacular collapses in the history of American corporations. Yet PGE's customers have not suffered from poor service as a result. Furthermore, PGE has an investment grade rating, as opposed to QC's speculative grade, or junk bond rating. PGE has continued to publish financial statements in conformance with generally accepted accounting principles, to generate positive cash flow from its operations, and to raise capital on reasonable terms as required. PGE's employment level has remained nearly constant over the past three years. This is not to say that PGE has been entirely unaffected by the Enron bankruptcy. But none of the horrible scenarios that Qwest posits for QC have occurred at PGE. Ex. 431 at 4-10.

87 Moreover, PGE has not made any bankruptcy filing. Qwest suggests that this means little, because QC is a larger corporation, relative to QCII, than PGE is to Enron. Ex. 178 at 8; (Cummings). But that fact alone does not make it any more likely that

QCII would bring QC into bankruptcy. There are several more salient reasons why it would not, as discussed in detail above.

88 A bankruptcy filing can even have a positive effect on affiliated companies. On May 14, 2003, NRG Energy filed for Chapter 11 bankruptcy reorganization. The regulated utility subsidiaries, Northern States Power and Public Service Co. of Colorado, as well as the parent, Xcel, were not included in the bankruptcy petition. S&P responded by upgrading the credit rating of Xcel and the utility subsidiaries to "positive creditwatch" as a result of the NRG filing. Banc of America Securities says that it expects Moody's to follow suit in the near future. Ex. 206.

89 Furthermore, as Dr. Blackmon noted, a bankruptcy filing by QCII could have a positive effect on QC in several ways. First, it could give QC access to the financial markets on much more reasonable terms than it has today. QC has a junk bond rating because of, and only because of, its parent company. Second, a bankruptcy filing could remove the cloud of questionable ethical, legal, and accounting practices that QC operates under today. Third, a change in ownership of QC could help restore a long-term perspective on telephone company investment decisions. Ex. 370 at 14. In sum, Qwest's dire predictions in the event of a QCII bankruptcy are contradicted by recent events, as well as the facts of this case.

F. Qwest and Dex Holdings' suggestion that Commission rejection of the Dex sale will result in a weakling Washington-only directory business is speculative and unrealistic.

90 Qwest and Dex Holdings suggest that if the Commission does not approve the Dex sale, Washington will become the directory ghetto, a stand-alone weakling to be preyed upon by rapacious publishers including Dex Media itself. This is simply unrealistic. A necessary component of this scenario is that the Washington portion of the directory business would have no viable means to realize any economic value, and be vulnerable to poaching. But the very fact that Dex Holdings is seeking to complete this sale for the Washington business undercuts that argument. Dex Media and its investors are willing to invest in the directory business only in circumstances where it is a quality asset – where, as here, it is designated as the official directory publisher of the dominant telephone company.

91 Dr. Selwyn noted that a Washington "stand-alone" directory publishing activity need not be the outcome. QC-Washington could enter into a publishing agreement with a multistate directory publisher under which it would convey the "official publisher" designation and associated rights in exchange for an ongoing license fee that would likely exceed the "revenue credit" proposed under the settlement. Such an agreement might well be made with another RBOC, such as Verizon, or possibly RH Donnelly. Ex. 363TC at 12-13; Tr. 1470. Alternatively, QC-Washington could enter into a publishing agreement with Dex itself, licensing the "official" status in exchange for an

ongoing license fee that would continue for as long as the publishing agreement remained in place. As Dr. Blackmon emphasized, QC would have several potential choices, and all would leave it a valuable and viable business enterprise. *Id.*

G. If the Commission decides to approve the Dex sale, then it should capture all possible gains for ratepayers and impose safeguards to prevent subsequent QCII raids on the assets of QC.

92 Staff urges the Commission to reject the proposed sale of Dex altogether, as it clearly harms ratepayers and is not in the public interest. However, should the Commission decide to approve the sale, then it should not accept the settlement agreement. Rather, it should adopt Staff's recommendations to capture all possible gains for ratepayers, and impose structural safeguards to protect the assets of QC from subsequent raids by QCII, as set forth below.

1. QC ratepayers are being asked to sacrifice benefits that are rightfully theirs to solve problems that are entirely of QCII's making.

93 The Commission must never lose sight of the reason why Qwest is here in the first place – it is seeking sacrifices from QC ratepayers to bail QCII out of problems that are entirely of QCII's making. Qwest is seeking to sell the lucrative directory publishing business – a decision that a healthy RBOC would never make – only to provide a one-time cash infusion for QCII. QCII got itself into its current debt-laden state through the poor performance of its non-regulated entities, including risky ventures, accounting irregularities, and allegations of corporate misfeasance. Through all of this, QC has been a strong, healthy, stable, and profitable company.

94 The irony of Qwest's position is that it admits that QCII's heavy debt load and poor financial condition ("extraordinary circumstances," as Mr. Reynolds calls it, Ex. 64C at 10) led to the Dex sale. Yet Qwest simultaneously contends, through its strenuous objections to Staff's proposed adjustments and safeguards, that the Commission must simultaneously pretend that these conditions do not exist, that they are not a threat to QC and its ratepayers now, and that they will not become a threat to them later. This is simply an untenable position. Qwest cannot have it both ways. If the Dex sale is to be approved, QC ratepayers must be adequately compensated and protected, both now and in the future.

95 If the Commission concludes that rejection of the Dex sale is unrealistic, then the transaction before the Commission constitutes what Standard & Poors calls a coercive transaction. Ex. 420 at 4. S& P objects when a bond issuer coerces bondholders into a transaction, and considers it a virtual bankruptcy. The coercing company is rated as if it had failed to meet its obligation to bondholders. If the Commission were to conclude that it had no choice but to allow the transaction –that it has been coerced by the company and the circumstances – then all of the approval-related conditions developed by Staff are appropriate.

2. If the Dex sale is approved, the Commission should require QCII to provide actual payments to QC, as well as an upfront payment of 10% of the Washington gain amount to compensate ratepayers for the additional risks that QC has created for them.

96 If the Commission concludes that it should approve the Dex sale, then the Commission should not do so under the terms of the settlement agreement. Instead, the Commission should require that QCII and QC enter into a contract in which QCII compensates QC each year for the expected amount that QC could otherwise realize from the directory publishing function. These amounts are shown in Ex. 371C. The contract should remain in place for as long as either the Publishing Agreement or the Noncompetition Agreement is in effect, and no amendments to the contract should be permitted without Commission approval. Ex. 370 at 24-25. This QCII contract mechanism permits QCII to use the proceeds of the sale transaction for reducing its debt, which is the stated reason for wishing to sell the directory business. It also provides QC customers with some protection from future rate increases, since the regulated utility would continue to receive payment as if it had not given up its right to be in the publishing business.

97 The Commission should also require, in addition to the contractual payments proposed above, that QCII provide Washington customers with a one-time payment equal to 10% of the net proceeds from the Washington state portion of the sale, or **CONFIDENTIAL < XXXXXXXXX END CONFIDENTIAL** (*Id.* at 25-26; Ex. 371C) to compensate them for the additional risks that QCII has created for customers of QC.

Both the annual payment and the one-time payment should be treated as operating revenues of QC for all regulatory purposes. The one-time credit is well within the amount set forth in the Material Regulatory Impact (MRI) provision in Section 5.4(b)(ii) of the Purchase Agreement, which requires QCII to consent to regulatory conditions with a financial impact of up to $500 million. Ex. 370 at 26.

98 As Dr. Blackmon points out, it is generally appropriate to use the gain on a sale to the benefit of the customers, and nothing about the circumstances of this transaction supports doing otherwise by allocating any portion of the gain for the benefit of the company and its shareholders. Qwest certainly should not receive a portion of the gain as a reward for management and strategy decisions that brought it to the brink of bankruptcy. Ex. 421C at 8. Nor is there anything in the Commission's prior decisions (including *Centralia Coal*) that dictate such a result.

99 Moreover, this certainly does not leave Qwest stockholders with no benefits as a result of the Dex sale. To the contrary, following Qwest's own logic, in comparison to the bankruptcy scenario Qwest's stockholders are the biggest winners, as they avoid the total loss in value of Qwest stock, roughly $7 billion. QC ratepayers lose even the larger value of future imputation benefits. In sum, then, Staff's proposed adjustments to the amount and timing of monies to be paid under the settlement agreement fairly balances the interests of shareholders and ratepayers, as set forth in the second principle of the Commission's *Centralia Coal* case (Second Supplemental Order, ¶ 29). Ex. 421C at 9.

3. If the Dex sale is approved, the Commission should implement Staff's structural safeguards to protect QC and its ratepayers from subsequent QCII raids on QCs' assets in the future.

100 If the Commission approves the Dex sale, it is equally imperative that the structural safeguards recommended by Dr. Blackmon be approved. The logic of Qwest's bankruptcy arguments again dictates this result. Qwest cannot argue that QCII's "exceptional circumstances" have brought it to this point, while not also acknowledging that those same circumstances (i.e., QCII's financial difficulties) require reasonable structural protections for the benefit of QC and its ratepayers.

101 RCW 80.12.020 provides that a sale of public utility assets cannot be done without Commission approval. The Commission is granted authority under RCW 80.01.040 to regulate public utilities "in the public interest." Hence, the Commission clearly may deny approval of the sale where, as here, it is inconsistent with the public interest. It follows that the Commission may conclude that it can approve the sale only if modifications are made which would render the overall transaction consistent with the public interest.

102 Furthermore, the Commission has broad authority pursuant to RCW 80.36.140 to regulate the practices of public utilities affecting rates. Staff's proposed structural safeguards related to QC (e.g., QC debt/equity ratio restrictions, restrictions on QC dividends, restrictions on QCII's use of QC debt) address precisely these types of practices. The existing practice, where QC is used by QCII as a source of

creditworthiness and cash, is unjust and unreasonable.[9] It has produced the result where a financially healthy public utility receives a junk bond rating. It borrows money it doesn't need at extraordinary interest rates. These cause direct harm to the regulated utility, by increasing its expenses and increasing its financial risk. The Commission should order that QCII cease this practice, which can be accomplished by imposing Staff's proposed safeguards.

103 Staff recommends that if the Commission approves the sale of Dex, at a minimum, QC be prohibited from taking any of the following actions until it first obtains a Commission order finding that the action is in the public interest:

1. Increasing the debt-to-equity ratio in Washington above the October 2002 level of 48.32%;
2. Increasing the dividend of QC to its common stock holder from the level paid in 2002; or
3. Lending cash or otherwise providing credit to QCII or any affiliate of QCII other than QC.

104 Finally, the Commission should required that any changes to the Publishing Agreement and any other ancillary or related agreement involving QC be made only with the Commission's approval. *See* RCW 80.16.010-.020 (Company having a

[9] On June 9, 2003, Qwest announced that it had refinanced $1 billion of debt issued to QC, which had been due in June 2003. The new loan amount has been increased to $1.75 billion, which Qwest states is due to "increased lender demand." Ex. 20, at 2.

management or service contract with a regulated utility is an affiliated interest, amendments to which are subject to Commission approval).

VI. CONCLUSION

105 The proposed sale of Dex is not in the public interest. The Commission should, therefore, disapprove the sale. It fails the Commission's no-harm test, does not provide fair value to QC, and deprives ratepayers of benefits to which they are entitled. If the Commission concludes that rejection of the sale is not a viable option, then it should capture all possible gains for customers and impose the safeguards recommended by Staff to prevent subsequent QCII raids on QC assets.

Respectfully submitted this 3rd day of July, 2003.

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