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**

POST HEARING BRIEF OF DEX HOLDINGS LLC

July 3, 2003

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MISCELLANEOUS

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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 POST HEARING BRIEF OF DEX HOLDINGS LLC

I. INTRODUCTION

1 The telecom industry in general and Qwest in particular are in the midst of what one witness aptly termed a "perfect storm." TR at 355 (Kennard).[1] But telecom is not alone in suffering financial difficulties. The Washington economy is suffering from downturns in airline, aerospace, software, and tech industries as well, to name a few. As the protector of the broader "public interest" of the state, the Commission should strive to create an environment in which public service companies can thrive in good times and survive in the bad. Doing so benefits not only the regulated companies, but also their customers, employees, and the state's economy.

2 In the long run, enlightened and forward-looking actions of this Commission, collectively with other state and local agencies, can create a positive, nurturing environment that signals

[1] Citations to "TR" refer to the page numbers of the transcript for the live testimony in this matter. The relevant witness is indicated in parentheses.

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industry to react appropriately to economic challenges, promotes investment, and encourages entry into the state. Alternatively, the Commission can take a myopic, punitive, and backward-looking approach in an attempt to provide short-term (and in this case risk-laden) benefits to a select group of ratepayers at the expense of the broader and longer-term public interest. That is a key choice the Commission faces in this case in comparing the Settlement[2] with the Staff's recommendations.

3 The Settlement is not harsh medicine that Qwest's ratepayers must swallow to avoid the uncertainties lurking on the horizon. The Settlement is a "win-win" agreement that arguably shares all of a sale price for Dex that was obtained through a highly competitive auction among the most highly-capitalized firms in the private equity market. The Settlement gives a present value of up to $1.2 billion[3] to Qwest's ratepayers over a time period that is balanced to provide sufficient up-front payments without placing undue financial burdens on Qwest. Most importantly, the Settlement minimizes risks to ratepayers by employing a sharing mechanism that provides the greatest possible protection from a Qwest bankruptcy at the same time as it eliminates the ratepayers' current exposure to reduction or loss of imputation due to bankruptcy, competition, technological change, and a myriad of other threats to the status quo that the Staff seeks to maintain indefinitely.

II. SUMMARY OF SALIENT ARGUMENTS

4 At long last, this proceeding presents the Commission with the opportunity to move beyond the stopgap measures that have characterized its treatment of Dex for the past two decades. For nearly twenty years, the Commission has withheld final approval of the 1984 transfer of the directory publishing business out of the LEC in an effort to protect ratepayers to the

[2] Exh. 2 (Stipulation and Settlement Agreement executed by Qwest, Dex Holdings, Public Counsel, AARP, WeBTEC, and DoD/FEA).

[3] TR at 756 (Kalt).

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greatest extent possible by (1) insisting on the receipt by ratepayers of fair value for their interest in Dex; (2) creating a process of imputing directory revenue to the LEC in ratemaking proceedings to preserve the status quo for the ratepayers in the interim; and (3) indulging in the regulatory fiction that Dex remains a part of the Qwest LEC as a means to make these stopgap measures work in a world where, for all other purposes, Dex has long been wholly separated from Qwest.

5 Today, neither this stopgap approach nor even a continued ratepayer interest in Dex promises to protect the public interest to the extent it has since 1984. The status quo that has prevailed for the past twenty years – steadily increasing, low-risk Dex profits that the Commission can rely upon in ratemaking proceedings – has vanished irretrievably, no matter what the Commission ultimately decides in this case. The telecommunications industry is rapidly changing, and the factual, legal, and policy foundations for imputation are also eroding apace. Factually, the Commission policy of requiring imputation arose when comparatively few competitive threats to either the incumbent LEC's directory publishing or local exchange businesses existed. Imputation was a relatively low-risk means through which to subsidize local telephone rates and adequately compensate ratepayers pending receipt of fair value for their interest in Dex.

6 Dex is currently facing its greatest competitive challenges in probably the last 80 years. The eastern half of the business has already been sold. Further, the legal and policy framework, both in Washington and nationwide, has evolved to promote the development of competitive local telecommunications markets and, as a corollary, the elimination of implicit subsidies from telecommunications rate structures. As a result, the Commission's rationale for requiring imputed directory publishing revenues to subsidize local exchange rates – a practice both the Commission and the Washington Supreme Court recognized as an interim remedy – no longer exists. Accordingly, the Commission should discontinue imputation and endorse the Settlement and sale of Qwest Dex to non-affiliate Dex Holdings, LLC.

7 This case also presents an opportunity for the Commission to acknowledge and address the risks facing Qwest Corporation and the uncertainty surrounding the future of the directory publishing business by approving a settlement that reduces those risks to ratepayers, locking in a substantial, time-limited revenue credit to replace the current, temporary, imputation scheme. The Staff's assertion that Dex will continue to produce increasing revenues in perpetuity is nothing more than wholesale speculation. It would be imprudent from both an economic and public policy standpoint to gamble on this unlikely outcome, with its attendant risks, and reject the certainty embodied in the proffered Settlement.

8 Aside from the long-term risk balancing involved here, there is an even more immediate issue facing the Commission in this case. Rejection of the Settlement may jeopardize the entire Rodney transaction, the completion of which is necessary for Qwest to avoid bankruptcy. *See* TR at 1126 (Reynolds) (discussing likelihood of Qwest going into bankruptcy under different scenarios). On this point, the Staff again displays naiveté by contending that bankruptcy might actually be good for Qwest and its shareholders. As several witnesses, including a former bankruptcy judge, testified, bankruptcy would severely harm ratepayers, shareholders and the general public, while complicating WUTC regulatory efforts. The Commission should make its decision with due regard for the big-picture implications for Qwest's continued solvency.

9 Both the Washington Supreme Court and this Commission have recognized that imputation may end when the time comes that Qwest (and by extension, its ratepayers) have received the fair value for Dex. *See U S West Communications v. Washington Util. & Transp. Comm'n,* 134 Wn.2d 74, 102, 949 P.2d 1337, 1352 (1998); *WUTC v. U S West Communications, Inc.*, Dkt. UT-950200*,* Fifteenth Supplemental Order at 38 (Apr. 11, 1996) ("[N]ever-ending imputation is [not] contemplated or attempted here."). The

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process Qwest followed was designed to, and did in fact, produce a sale of Dex for full market value. The evidence shows that the sale was a competitive auction in a market environment where assets such as these were scarce and highly valued. *See* TR at 260 (Kennard); Exh. 241 (Kennard Direct) at 11-12 ("Qwest conducted a robust auction for the sale of Dex. Bidders included several of the country's most well-funded private equity firms. Therefore, the purchase price reflects the market's best assumption of future profits."). The Settlement unquestionably provides Qwest's ratepayers with a fair share of the gain realized on that fair price.

III. DISCUSSION AND ARGUMENT

10 The ultimate decision that this Commission must make is a reasonable balancing of the risks and benefits embodied in the two alternate futures presented by acceptance or rejection of the Settlement. The Commission should not place weight on the Staff's pie-in-the-sky theories about what might have been or what might be. Instead the goal should be an outcome that best protects Washington ratepayers over the long term. In the words of one of the Staff's own witnesses:

> [Y]ou need to temper reality with . . . what it ought to be and come up with some solution that balances what you should be doing . . . in an ideal situation, versus what a pragmatic result would require.

TR at 988 (Selwyn). The Settlement reflects exactly this kind of balancing approach by accommodating the exigencies of Qwest's current financial situation, compensating ratepayers for the fair value of the Dex business, and setting the stage for the growth of additional local competition in the future. Based on prior Commission decisions, the proposed transaction either provides benefits or at least "does no harm" and should be approved.

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A. Historical Background and Present Legal and Factual Context

1. <u>The Yellow Pages Business Has Been a Point of Contention and Controversy Since the Breakup of the Bell System.</u>

11 Since at least 1982, the status of, and proper accounting treatment for, revenue derived from LECs' telephone directory publishing businesses have remained contentious legal and regulatory issues fraught with uncertainty.[4] These issues arose with entry of the Modified Final Judgment in *United States v. AT&T*, 552 F. Supp. 131 (D.D.C. 1982) ("*Modified Final Judgment*" or "*MFJ*"), *aff'd sub nom*, *Maryland v. United States*, 460 U.S. 1001 (1983), which, as its fundamental purpose, sought to promote the development of competition in interexchange and related markets. Consistent with this objective, the court determined that the regional operating companies, and not AT&T, ought to have possession of directory publishing assets. The court struck the portion of the negotiated consent decree that prohibited Bell operating companies ("RBOCs") from publishing directories, because it deemed this provision anti-competitive:

> [T]he prohibition on directory production by the Operating Companies is distinctly anti-competitive in its effects, for at least two reasons. In the first place, the production of the Yellow Pages will be transferred from a number of smaller entities to one nationwide company – AT&T. This type of concentration is itself anathema to the antitrust laws. Furthermore, possession of the franchise for the printed directories will give AT&T a substantial advantage over its competitors in providing electronic directory advertising – a market in which the Operating Companies will not be engaged.

MFJ, 552 F. Supp. at 193-94 (footnote omitted). Recognizing that the BOCs would retain virtual monopolies over local telephone service, the Court explained that requiring the

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[4] *See, e.g., In re Pacific Northwest Tel. Bell Tel. Co.*, Cause No. U-89-3524-AT, Second Supplemental Order, at 33 (Nov. 9, 1990) (dissenting from endorsement of the U S West rate case and AFOR settlement agreement "because the proposed settlement agreement forfeits an opportunity to once and for all, resolve the issue of US West's directory publishing revenues") (Commissioner Pardini, A., dissenting); *see also* Exh. 101 (Grate Direct) at 21-22 (describing how the loss of copyright protection for directories, the promulgation of federal regulations governing the cost and availability of subscriber listings, computerization, and the entrance of competitive local exchange carriers have increased risk and uncertainty for the directory publishing business).

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directory publishing business to remain with the BOCs would have the ancillary benefits of allowing directory publishing revenue to continue to subsidize rates and protecting consumers from monopolistic pricing. *Id.*

2. <u>This Commission Has Dealt With Qwest Yellow Pages Issues in Numerous Dockets.</u>

12 The contention quickly spread from the Federal courts to the states. Shortly before the effective date of AT&T's divestiture of the BOCs, Qwest's predecessor and other BOCs placed their directory publishing businesses into separate subsidiaries. This resulted in numerous state commission proceedings. Indeed, during the past twenty years, this state Commission has, on at least eight different occasions, considered (directly or indirectly) the propriety of imputing earnings from the Company's directory publishing business to its regulated operations. *See* Appendix A (documenting the Commission's consideration of the imputation issue).

13 While the Commission conditionally approved several intra-company transfers of the Company's directory publishing business, it has repeatedly expressed concern that the transactions were not arms' length bargains for fair market value:

- In **1983**, the Commission conditionally approved the Company's transfer of the directory publishing business to Landmark Publishing Company ("Landmark"), but expressed concern that the transaction between the Company and its unregulated affiliate was not an arms' length transaction. *See In re Pacific Northwest Tel. Bell Tel. Co.*, Cause No. FR-83-159, Order Granting Application, in Part (Dec. 30, 1983);

- In **1985**, the Commission conditionally approved a revised publishing agreement between the Company and Landmark, but once again expressed concern that the transaction with the affiliate was not undertaken at arms' length. *See In re Pacific Northwest Tel. Bell Tel. Co.*, Cause No. FR-83-159, Fourth Supplemental Order (Jan. 16, 1985); and

- In **1988**, the Commission rejected a publishing agreement it believed unreasonable, explaining that the "public interest requires that the full reasonable value of the directory publishing enterprise be deemed available to [the Company] for rate-making purposes. The remedy selected to achieve this goal should, as far as possible, reflect true values and market realities as if the transfer had been an arms length transaction, with each party seeking to maximize return. . . . ***[T]hese [publishing] contracts do not represent such***

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> ***an arms length transaction.***" *In re Pacific Northwest Tel. Bell Tel. Co.*, Cause No. U-86-156, Second Supplemental Order, at 16 (Oct. 11, 1988) (emphasis added).

14 As these decisions illustrate, ensuring that the Company and its ratepayers receive a fair share of the market value for the directory publishing business is – and ought to be – a paramount Commission concern. As described below, the Settlement effectively and conclusively addresses this concern.

3. <u>The Commission's Use of Imputation Was Appropriate When Ordered.</u>

15 Since 1984, when Qwest first transferred its directory publishing business from the LEC to an unregulated affiliate, the Commission has required Qwest to use imputed directory publishing revenues to reduce the LEC revenue requirement, animated by two concerns. **First,** the Commission sought to ensure that ratepayers would ultimately receive fair market value for whatever interest they possess in Dex, and perceived imputation as a guard against any collusive aspects of the affiliate transfer that otherwise would deprive ratepayers of compensation for that interest. *See In re Pacific Northwest Tel. Bell Tel. Co.*, Cause No. FR-83-159, Order Granting Application, in Part, at 2 (Dec. 30, 1983). Indeed, the Commission recognized that imputation was required only because the Company was transferring the directory publishing business to an affiliate without any reciprocal transfer of fair market value for that business back to the LEC.

16 **Second**, the Commission has – in evaluating any transaction involving the Company's directory publishing business – sought to protect the public interest by preserving "affordable universal telecommunications service" and ensuring that "customers pay only reasonable charges for telecommunications services." *See, e.g., In re Pacific Northwest Tel. Bell Tel. Co.*, Cause No. U-86-156, Second Supplemental Order, at 21 (Oct. 11, 1988). In the pre-1996 world of *de facto* monopoly local service providers, the Commission made full use of directory publishing revenues as an implicit local exchange subsidy to promote universal service, as permitted by the *MFJ*, 552 F. Supp at 193-94.

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17 As detailed below, the Commission should continue to embrace the ideals embodied in these two familiar touchstones and endorse the Settlement which (**i**) promotes competition while providing for a reasonable transition away from the implicit subsidy that imputation represents; (**ii**) reflects an arms' length transaction which resulted in a fair market value sale of the Company's directory publishing business; and (**iii**) serves the public interest.

4. <u>Today's Environment Calls for New Approaches and New Tools.</u>

18 Particularly since the enactment of the Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996) ("Telecommunications Act"), the governing laws and regulations, the demands of the market, and the technology available to directory publishers have all evolved rapidly to create a fundamentally different world in which the Commission's old standbys will no longer serve. Dex is now facing greater uncertainty and more significant threats to its core directory publishing business than it has at any point in the last 80 years. *See* Exh. 242C (Kennard Rebuttal) at 13-14, 18 (describing the risks facing the directory publishing business).

a. Federal and Washington Law and Regulation Now Explicitly Favor Competition in Local Telecommunications and Related Markets.

19 Since imputation was first ordered, there have been significant changes in federal and state telecommunications laws and regulations for the Commission to consider in deciding this case. **First**, at the federal level, the Telecommunications Act codified Congress's determination to promote competition in local telecommunications and related markets. *See*, *e.g.*, 47 U.S.C. § 251. Among other changes, the Telecommunications Act and the implementing rules and regulations of the FCC facilitate competition among rival directory publishers by requiring LECs to provide nondiscriminatory access to their subscriber list information ("SLI"), such as the names, addresses, and telephone numbers of local exchange customers. 47 U.S.C. § 222(e); *see* Exh. 242C (Kennard Rebuttal) at 13-14; *Telecommunications Carriers' Use of Customer Proprietary Network Information & Other*

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Customer Information, Third Report and Order in CC Docket No. 96-115, Second Order on Reconsideration of the Second Report and Order in CC Docket No. 96-98, and Notice of Proposed Rulemaking in CC Docket No. 99-273, 14 FCC Rcd 15550 (1999). These changes place competing directory publishers on more equal footing with the "official" publisher of the incumbent LEC and, indeed, at least one of Dex's major competitors – Verizon – has recently launched competing directories in a significant number of Qwest markets and is rapidly ramping up competitive operations in others. *See* Direct Exh. 242C (Kennard Rebuttal) at 13. The law in Washington embraced competition even before the Federal Act. *See, e.g., In re Electric Lightwave*, 123 Wn.2d 530, 869 P.2d 1045 (1994); *WUTC v. U S West Communications, Inc.*, Docket UT-941464 *et al.*, Fourth and Sixth Supplemental Orders (1995).

20 **Second,** in embracing local competition as the law of the land, the Telecommunications Act also eliminated reliance on implicit subsidies as a means of supporting universal service. 47 U.S.C. § 254(e) ("[a]ny such support should be explicit"); *Comsat Corp. v. FCC*, 250 F.3d 931, 938 (5th Cir. 2001) ("'[T]he plain language of § 254(e) [of the Act] does not permit the FCC to maintain any implicit subsidies.' . . . . [U]niversal service support must be explicit.") (*quoting Texas Office of Public Utility Counsel v. FCC*, 183 F.3d 393, 425 (5th Cir. 1999) (*citing Alenco Communications, Inc. v. FCC*, 201 F.3d 608, 623 (5th Cir. 2000)). Such implicit subsidies hamper the development of local competition and are thus inconsistent with the fundamental premise of the Telecommunications Act.

21 **Third**, as part of this move toward greater competition, in the Telecommunications Act, Congress removed the entire legal framework and underpinnings of Judge Greene's decision in the *MFJ*. *See* Telecommunications Act, § 601(a)(1), 110 Stat. at 143 (codified at 47 U.S.C. § 152 note); *United States v. Western Elec. Co.*, Civil Action No. 82-0192 (HHG), 1996 WL 25594 (D.D.C. April 11, 1996) (vacating the *MFJ*). Congress expanded on Judge Greene's competitive vision to embrace competition in local

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telephone service. As discussed above, the Telecommunications Act outlawed implicit universal service subsidies and adopted a pro-competitive approach in local markets that was inconsistent with the *MFJ*'s accommodation of implicit directory publishing subsidies. The incidental consequence to the *MFJ*'s central objective of promoting competition – use of directory publishing revenue to subsidize the rates of regional operating companies – remained (and continues to remain) in place, however, as an anachronism:

> Following the breakup of the Bell system, the [Washington Utilities and Transportation Commission's] use of imputation (or the equivalent) was an understandable response to the restructuring of the industry and the transition to a more dynamic and competitive setting. However, in the presence of sound and clearly established goals of enhanced competition and reliance on marketplace forces for determining the quality, packaging, and pricing of local exchange services, the public's interest is not served by perpetual use of cash flows from an unregulated business to reduce prices charged by the ILEC [incumbent local exchange carrier] as it competes with competitive carriers. In fact, if the policy of promoting competition were successful, the very success of the policy would eliminate the basis for imputation entirely.

Exh. 261C (Kalt Rebuttal) at 13.[5]

22 While the principle of *stare decisis* requires deference to past decisions, it recognizes that tribunals must adapt to changed circumstances. *In re Stranger Creek*, 77 Wn.2d 649, 653, 466 P.2d 508, 511 (1970) ("stability should not be confused with perpetuity"); *see also* RCW 80.04.210 ("Commission may change orders"). The Commission has already recognized that it is appropriate in this docket to revisit past imputation decisions in the context of a full, final, and arms-length sale of Qwest's directory business. Fifth

[5] The Commission, the Federal Communications Commission (the "FCC"), and the courts have all confirmed that Qwest has no monopoly over local service in Washington. *See, e.g., In Re Electric Lightwave*, 123 Wn.2d 530, 869 P.2d 1045 (1994) (confirming that Qwest does not have a *de jure* monopoly in Washington); *Application by Qwest Communications International, Inc. for Authorization To Provide In-Region, InterLATA Services in the States of Colorado, Idaho, Iowa, Montana, Nebraska, North Dakota, Utah, Washington and Wyoming*, Memorandum Opinion and Order, 17 FCC Rcd 26303 (2002) (concluding that Qwest Corp.'s local exchange markets are open to competition).

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Supplemental Order Denying Motion to Strike (May 2, 2003), at 3 ("This is not the context of our prior consideration of imputation in various dockets, nor of the Supreme Court's discussion and decision of this subject. Indeed, the Supreme Court expressly contemplated that the issue of ending imputation might be considered anew" when Qwest could show it had received fair value for Dex.). In evaluating the Settlement in this proceeding, the Commission should also – to the extent it relies upon language in the *MFJ* to support subsidies and imputation as a means of protecting ratepayers – recognize that the fundamental purpose of the *MFJ* was to protect ratepayers by preserving and promoting competition and that serving that end in today's environment requires a transition to a new approach.

b. Technological Evolution Threatens the Foundations of the Print Directory Business.

23 With unfettered access to LEC SLI, a multitude of directory publishers, including publishers of Internet-based directories, are bringing to market products and services that allow customers to obtain more information that is more tailored to their individual needs than any print directory could ever offer. Exh. 242C (Kennard Rebuttal) at 14 ("[C]ompetitors are increasingly using this listing information as the basis for competing printed directories, Internet-based directories, CD-ROM directories, wireless and wireline voice-portal directories, and others. In the not-too-distant future, wi-fi-enabled devices, wide area broadband, and 3G wireless technology, just to name a few possibilities, may challenge the primacy of printed directories."). As just one example of the many business risks that Dex faces, there is the proliferation of advanced devices. Mr. Kennard explained:

> [I]n my briefcase there, I've got a little wireless data device which is also a phone, and I can click on the numbers in my address book once, find a name, and then click again and it makes a call for me to that person. Well, it won't be long before people use those devices to access a wireless portal that has a Yellow Page directory in it. And if you want to buy a pizza, for example, you click on pizza and click three or four times and you've got the call.

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TR at 337 (Kennard). Apart from the technological challenges, the tie to Qwest no longer exists with these new devices.

c. The Market for Directory Products Increasingly Demands Capabilities That Are Beyond the Capability of a Printed Directory to Provide.

24 Changes in the demands of the market for directory products reflect these evolutions in technology. As Mr. Kennard testified, "customers demand access to directory listings and related information in new formats over a host of new platforms. Exh. 241 (Kennard Direct) at 14. So far, Dex has attempted to meet these demands through products such as secondary directory products like "On-the-Go" directories intended for use in the car and the QwestDex.com Internet-based directory. As customers are increasingly able to access easily-updatable, customized, mobile, online directory information, market demands for this type of access will grow and consumers will be more likely – and certainly more able to – bypass the printed telephone directory in favor of these more personalized, flexible, and informative options.

25 To meet these challenges, Dex will need to evolve substantially from a leading publisher of print directories into a provider of new categories of business information across multiple new platforms. The development of these new product and service offerings, not to mention the organizational and cultural change necessary to succeed, will at a minimum require Dex to invest considerable resources that promise to place its earnings under pressure for years to come. At worst, as part of an incumbent LEC organization facing considerable financial pressure of its own, Dex would be unable to succeed in this transition.

B. The Standard of Review Under the Public Interest Test, as Articulated by This Commission.

26 The Commission in this case must determine whether the sale of Dex in general and the Settlement in particular are in the public interest. RCW 80.01.040. The legislature has not

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specifically set forth the standards for reviewing transfers of property. *Cf. FCC v. WNCN Listeners Guild*, 450 U.S. 582, 593 (1981) (In examining the public interest standard under the federal Communications Act, "[i]t is common ground that the Act does not define the term 'public interest, convenience and necessity.' The Court has characterized the public-interest standard of the Act as 'a supple instrument for the exercise of discretion by the expert body which Congress has charged to carry out its legislative policy.'") (*quoting FCC v. Pottstown Broadcasting Co.*, 309 U.S. 134, 138 (1940) (footnote omitted).

27 With respect to property transfers, however, the Commission is explicitly empowered to adopt rules implementing the property transfer statutes. RCW 80.12.050. The test the Commission has adopted by rule is:

> If, upon the examination of any application and accompanying exhibits, or upon a hearing concerning the same, the commission finds the proposed transaction is not consistent with the public interest, it shall deny the application.

WAC 480-143-170. The rule is phrased in the negative. The Commission need not find the transaction **is** in the public interest to approve it. Rather, it will deny and application if it finds the transfer is not in the public interest. When considering a proposed transfer of utility-owned property to an unaffiliated entity, therefore, this Commission has held that the transfer is in the public interest, and should be approved, if the applicant can show that, on balance, the transfer does "no harm." *See Application of Avista Corp., et al., for Authority to Sell Its Interest in the Coal-Fired Centralia Power Plant*, WUTC Consolidated Docket Nos. UE-991255, UE-991262, UE-991409, Second Supplemental Order, Order Approving Sale with Conditions (hereinafter, "*Centralia*"), at ¶ 29 (Oct. 14, 1999). In *Centralia*, the Commission listed four non-exhaustive factors to weigh when considering the transfer: "(1) the rates and risks faced by ratepayers, (2) the balance of interests among customers, shareholders, and the broader public, (3) the effect of the transaction on competitive markets, and (4) protection of the interests of Washington ratepayers." *Id*.

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28 The Commission was clear to point out in *Centralia* that the four enumerated factors are not "minimum standards" but rather "guidelines that, when taken together, can be used to determine whether there is, at least, no harm to the public interest." *Id*. Contrary to the Staff's formalistic posture in this case, the *Centralia* decision suggests that a more holistic approach is required and that the "unique mix of factors each transaction presents for evaluating risks and benefits will dictate that [the four factors] apply in different measure." *Id*. Considering the factors as a whole in this case demonstrates that not only does the sale "do no harm," but it also produces **positive** results for all involved.

C. Approval of the Sale and Settlement Is in the Public Interest.

29 Because the Settlement promotes competition between local exchange carriers and shares with ratepayers the majority of the gains Qwest realized from an arms' length transaction that resulted in a fair market value price for its directory publishing business, the Commission's ratification of it will necessarily benefit the public interest. Indeed, the sale of Qwest Dex contemplated by the Settlement will benefit the public for several reasons:

- The sale of the Company's directory publishing business will ensure that the Company remains a financially viable concern able to maintain its network and provide quality service to its retail and wholesale customers. Indeed, the sale of Qwest Dex is a central component of the Company's plans to avoid bankruptcy and restructure its debt – critical threats to its ability to provide quality and reliable service in Washington. *See* Exh. 172 (Cummings Direct) at 14-20;

- The sale ensures that the Company immediately gains the value of Qwest Dex while avoiding the future risk that competition will erode the revenue stream from the directory publishing business. Because regulatory, technological, and market risks (described in Section III.C.1, *infra*) may decrease the directory publishing revenue available for imputation, the sale (**i**) allows the Company to realize the significant and necessary benefit required to address core business needs; and (**ii**) protects ratepayers from rate increases due to declines in Qwest Dex revenue while providing them with a tangible benefit;

- Rather than obligating the Company to use directory publishing revenue to service debt and subsidize local exchange rates, the sale permits an independent purchaser to use profits to innovate – research and develop new products, maximize the value of the directory publishing assets, and provide new services to both consumers and advertisers. *See, e.g.*, TR at 342 (Kennard);

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- The Company does not propose to increase rates as a result of the sale. *See* Exh. 61 (Jensen Direct) at 40-41. Indeed the structure of the revenue credits, which last through 2018, is a deterrent to a Qwest rate case filing. TR at 1283, 1287-88 (Brosch).

30 The sale will foster a more competitive telecommunications environment which will benefit all consumers (including those who choose to remain with the ILEC) as market forces will discipline the prices, service offerings, and efficiency of local exchange carriers. "The Washington public has an abiding interest in the sound functioning and regulation of the markets for local exchange services." *See* Exh. 261C (Kalt Rebuttal) at 12.

31 These advantages – unlike those advanced by Dr. Selwyn's narrow and short-run assessment of the public interest – not only benefit all Washington consumers, but also take into consideration the dynamism of regulatory and technological change. *Compare* Exh. 311 (Selwyn Direct) at 5 (employing limited ratepayer indifference standard) *with* Exh. 261 C (Kalt Rebuttal) at 12-13 (describing broad-based public interest standard). Selwyn and Commission Staff incorrectly focus their public interest analysis solely on the Company's ratepayers, rather than all Washington telecommunications consumers and residents. A broader focus is consistent with the totality of concerns that actually constitute the public interest. *See, e.g., Centralia* at ¶ 29.

32 Viewed from the broader perspective detailed above, the Settlement and the Company's sale of the directory publishing business to Dex Holdings, LLC is conclusively in the public interest.

1. *Centralia* Factor 1: The Rates and Risks Faced by Ratepayers

33 Currently, and absent approval of the Settlement, Qwest's ratepayers face a panoply of risks. The Staff's assumption that denial of the sale will preserve the status quo forever is simply overly simplistic at best and reckless at worst. Mr. Kennard captured the level of uncertainty and risk facing Dex as follows:

> It seems to me that the testimony of Drs. Selwyn and Blackmon simply proceeds from an overly-optimistic outlook on the future of the

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> directory publishing industry. They contend that our purchase price was too low, and that the risk we perceive in the industry is largely nonexistent. We at Carlyle and WCAS do not have the luxury of viewing the industry through such rose-colored glasses. As investors, we cannot afford to believe on blind faith that the printed yellow pages directory will continue the upward trajectory it has traced for the past twenty years. . . . Dex no longer can be viewed as a proverbial goose that will lay an ever-increasing number of golden eggs.

Exh. 242C (Kennard Rebuttal) at 16-17. The record is replete with information on the myriad possible ways in which continued ownership of Dex could go horribly awry for ratepayers, if the Commission were to deny approval of the sale or reject the Settlement. The consequences for ratepayers of such action range from harmful to disastrous. Dex Holdings defers to Qwest's analysis of its own financial straits and the implications for itself and QwestDex of the various QCII and Qwest Corp. bankruptcy scenarios discussed in the record, but pauses to note that it is plain that QCII faces a substantial risk of bankruptcy that would be mitigated by the Dex sale. In addition to the considerable risks associated with the various Qwest Corp. and QCII bankruptcy and foreclosure scenarios, however, ratepayers face substantial other risks, summarized in the following sections.

a. Isolation of the Washington Directory Publishing Operation Would Precipitously Reduce Dex Revenues and Associated Imputation.

34 The Commission cannot hope to maintain the status quo that has prevailed for the past two decades under the imputation regime by withholding its approval for the Dex sale, for at least two reasons. **First,** Qwest and Dex Holdings have already closed the sale of Dex in seven eastern Qwest states, changing the economics of the western region for Qwest irrevocably. The directory publishing business is one with substantial economies of scale. *See* TR at 445 (Burnett). There are a multitude of functions, such as IT, HR, and the mechanical directory publishing "operations," that can be handled more efficiently by a large regional publisher than they can by a smaller one. In the event that the parties were to negotiate an agreement to close the six remaining western states, not including Washington,

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QC would be required to publish Washington directories on a "go it alone" basis, and likely would be unable to do so nearly as profitably as it does today.[6]

35 Immediately after such a 6-state closing, the Washington directory publishing operation likely would be faced with substantial costs to reconstitute critical functions, including systems, IT, operations, and possibly sales personnel, that would have been transferred to Dex Media. TR at 445 (Burnett). At the same time, it would remain obligated to publish a directory roughly every 15 days in Washington. *Id.* at 444. Whether it sought to rebuild the necessary capabilities or whether it sought to outsource those functions to a third-party publisher, substantial portions of the directory publishing profits that Washington otherwise could generate would need to be invested in covering these increased costs. TR at 351-52 (Kennard). Undoubtedly, in the short term, Washington directories would decline in quality. Even assuming, for sake of argument, that most of the value of Dex is based on the LEC affiliation, Qwest's hypothetical standalone Washington directory business would still lose these economies of scale, as those are based on the association with the other 13 states. *See*, *e.g.*, TR at 445-49 (Burnett).

36 **Second,** the stand-alone Washington publisher would face heightened competition from Dex Media West, a "super-competitor" poised to gather Washington market share using its geographically-contiguous operations and decades of first-hand experience and expertise in publishing Washington directories. *See id.* at 421-22, 439-40, 447-48. Faced with such a "super competitor" entrant and two roughly equal directory publishers, advertisers would need to split their advertising budgets among the books with smaller ads (and lower

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[6] QC will receive the equivalent of the current imputation scheme **only** if nearly all value of the business is in the affiliation with the LEC. The evidence shows it is actually only 10 percent to at most 30 percent of the value. *See* Exh. 243 (FAS 141 Report); TR at 287-88 (Kennard). In the worst case scenario, if QC cannot get a publisher agreement at all, it may have to **pay** a publisher to meet its white pages regulatory obligations. TR at 611 (King).

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revenues) for each book. The heightened competition would be virtually certain negatively to impact Qwest's Washington directory revenues. *Id.*

b. QC Retains All of Dex West, but Successfully Mounts a Challenge to the Current Imputation Methodology.

37 Qwest has raised significant issues in this proceeding regarding whether revenues from secondary directories, non-Qwest listings, or new ventures, such as Internet-based directories, should properly be included in the imputation calculation that has been a part of every recent Qwest rate case in Washington. *See* TR at 458-59 (Koehler-Christensen). Given that non-Qwest listings alone comprise some 25 percent of all listings in Dex directories, Exh. 131 (Koehler-Christensen Rebuttal) at 18, a substantial sum would be at issue. The current Settlement avoids the risks to the ratepayer imputation stream that would attend litigation of these issues. Were the Commission to reject the Settlement and withhold approval of the proposed sale, these issues would almost certainly arise in the next Qwest rate case.

38 Alternately, Qwest may challenge the rate of return attributed to Dex – currently Qwest's authorized rate of return on regulated operations of 9.367 percent, including a return on equity of 11.30 percent. Evidence based on the negotiations with Dex Holdings suggests that the market believes a compensatory rate of return could be significantly higher. *See* Exhibit 252. If Qwest were to successfully apply a competitive rate of return to Dex, the current imputation could decline significantly.

c. Income Available for Imputation Declines Over Time.

39 As discussed above, legal, technological, and market-based changes to the directory publishing industry have fundamentally changed the competitive landscape Dex faces. These changes are creating increased competitive entry and shifting market demands that already are taking their toll on the printed directory business. Recently Dex has experienced declining revenues, usage, and number of advertisers. TR at 336-337

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(Kennard); TR at 430-431 (Burnett) (stating that Dex top-line revenue growth deteriorating since late 1990s); TR at 610-11 (King) (stating that, over time, the Yellow Pages could lose their value, with corresponding decline in imputation); TR at 783-84 (Kalt) (stating that competition growing in directory publishing industry).

40 The Settlement, in contrast, provides ratepayers with certainty for the foreseeable future that their telephone rates will not depend on how the market for telephone directories develops in the future, advancing the public interest. The Commission should not speculate on this industry with ratepayer money, especially when the market has already concluded that the directory publishing business is considerably more risky than the 9.367 percent the Commission allows Qwest when computing imputation.

d. Litigation Risks Would Result From Rejection of the Settlement

41 If the Commission were to reject or modify the Settlement reached in this case, it could derail all or part of the Dex Media West transaction, with the myriad negative consequences for ratepayers and imputation that are described above. Either of two possible outcomes from such action could ultimately cause great harm to ratepayers. **First,** uncertainty caused by litigation on appeal could delay closing beyond the December 15, 2003 "drop dead" date negotiated between the parties, causing the sale to fall through. In this proceeding, with so many parties participating in the settlement, the likelihood of an appeal if the Commission departs from the settlement terms is relatively high. As Dr. King noted, "[m]y recommendation is to adopt the settlement, and the reason is that the settlement is a . . . done deal, that there is no hanging risk over the realization of return of benefit to ratepayers." TR at 616 (King).

42 **Second**, even if Qwest closed the Dex Media West transaction, possible legal challenges to any Commission order that alters the settlement could strip the ratepayers of the benefits

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they would otherwise obtain from the settlement.[7] Were a court to accept jurisdictional arguments based on Commerce Clause or other arguments, or substantive arguments that the ratepayers are not entitled to compensation under the *Democratic Central Committee* test (discussed below), then the ratepayers could walk away empty-handed.

e. Staff Inappropriately and Naively Dismisses the Risks.

43 Staff's analysis in the case fails to even acknowledge, let alone analyze these risks to continued imputation of yellow pages revenues. Staff's response to Qwest's and Dex's analysis is to dismiss it cavalierly with the retort that Dex would not have agreed to buy the business if it were truly risky. *See*, *e.g.*, Exh. 370 (Blackmon Direct) at 8. This response begs the issue, however, since capitalization of the risk is inherent in the offering price. The combination of Staff's arguments that the price was too low and there is no risk reveals the flaws of both arguments. The price is at the low end of the range of estimates and below the Staff's guess as to fair market value **because** the business is subject to significant risks that the Staff has failed to appreciate.

44 While staff failed to do much in the way of analysis of the risks inherent in the status quo, at least one of the staff witnesses, Dr. Selwyn, understands the importance of managing risks:

> Q. When you buy fire insurance for your house, Dr. Selwyn -- well, I assume you do have fire insurance on your house?
>
> A. I do.
>
> Q. And when you buy that insurance policy every year, do you expect that your house is going to burn down in that particular year?
>
> A. No.

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[7] Qwest could accept the risk that the courts would affirm and proceed with the closing. But doing so would not preclude Qwest from appealing the conditions. The ratepayers would then face substantial litigation risks, as discussed here. If the Settlement is approved as presented, neither Qwest nor any other party can appeal.

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Q. Do you expect your house is never going to burn down, Dr. Selwyn?

A. I expect that it might. That's why I buy insurance.

Q. Okay. So in other words, you're managing that risk?

A. Yes.

TR at 968 (Selwyn). Dr. Selwyn went on to agree that it is not prudent "to try to maximize the dollars in your pocket" by foregoing the fire insurance premium in the face of a risk of such magnitude. *Id.* at 968-69. The same principle applies to review of the Settlement. It is not worth risking a total loss to try to extract a few more dollars from Qwest. Staff should not be gambling with the ratepayers' dollars when the ratepayers themselves have evaluated the risks and agreed to a Settlement that strikes a reasonable balance.

f. Approval of the Settlement Eliminates Nearly All the Risks and Minimizes the One Risk Not Eliminated.

45 In contrast to the many risks inherent in rejecting the Settlement, and even more risks in rejecting the sale outright, approval of the Settlement exposes ratepayers to but one risk, a risk that is manageable and much more remote than the risks of rejection. *See, e.g.,* TR at 720 (Mabey); TR at 557-58 (Cummings); TR at 779-80 (Kalt). That one risk is that Qwest may go bankrupt at some point in the future and thereby threaten the deferred repayment of the gain. However, the only competent evidence in the record shows that the revenue credit approach in the Settlement is the best possible protection the Commission could adopt. *See*, *e.g.*, TR at 719, 738-39 (Mabey) (revenue credit is "very secure mechanism"). Weighed against the considerably greater likelihood of a Qwest bankruptcy if the Dex Media West transaction does not close, and given that there are NO protections for the ratepayers currently in place under such a scenario, the appropriate way to balance the risks should be obvious. Moreover, the evidence strongly shows that the Dex sale makes the risk of a Qwest bankruptcy very remote. *See* TR at 355 (Kennard).

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46 Even beyond the bankruptcy-related benefits of a revenue credit, this mechanism provides the Commission with maximum flexibility to accommodate the risk of changing market conditions in the future. As Dr Kalt explained, it is difficult to predict with certainty what solution today might best serve the ratepayer interests over a decade from now:

> A: [T]here are states of the world in which, such as [year] 13, 14, 15, competition is now fully in place, and so forth and so on. There are states of the world in which in a sense your policies have delivered rate payers benefits through another avenue, through the introduction of competition . . . . [T]hat leaves you saying let's put in place a process that removes this imputation from business risk.
>
> Q: So you're saying if in the end the credit isn't given, if it's because other companies were offering lower prices and the rate payers got a different kind of good deal even though they didn't get the payout that – we originally said they were entitled to.
>
> A: That's correct, or different services, you know, new technology services or whatever, yes.

TR at 776-77 (Kalt).

2. <u>*Centralia* Factor 2: The Sale And Settlement Balance The Interests Among Customers, Shareholders, and The Broader Public.</u>

47 Faced with the market-based, regulatory and financial uncertainties as described in detail in Section III.C.1., *supra,* it is in all parties' best interest for the Commission to permit the sale to proceed in accordance with the terms of the Settlement. As will be described in more detail below, it is in all parties' interests to avoid a Qwest bankruptcy and the losses, disruption and uncertainty that would follow. Yet even putting aside the issue of bankruptcy, the sale, like other spinoffs of non-core assets from a regulated utility, will actually maximize the value of those assets to investors, ratepayers and the public. In this case, the transfer of the assets to a highly-capitalized company with a strong track record for innovatively managing businesses in the telecommunications industry will maximize the value of the publishing business and most effectively balance the interest of those affected by the sale.

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a. *Dex Media Is in a Better Position Than Qwest to Meet the Directory Needs of Customers and the Public.*

48 The evidence in this case stressed the difficult financial position in which Qwest has found itself. *See* Exh. 172 (Cummings Direct) at 8-12. In addition to creating the prospect of bankruptcy, Qwest's financial condition makes it not well-suited to provide innovative and expanding directory service to customers in Washington state. Despite an ambitious five-year strategic plan, George Burnett, Qwest Dex's Chief Executive Officer, testified that customers would in fact receive better quality directories in a shorter time if the publishing business was transferred to Dex Media. *See* TR at 439 (Burnett) ("The advertiser and the consumer will get a better product sooner"). This is in part because Dex Media can draw on the substantial financial backing of both The Carlyle Group and Welsh, Carson, Anderson & Stowe, which together have over $13 billion under management. *See* Exh. 241 (Kennard Direct Testimony) at 4. In addition, once the publishing business is separated from Qwest, Dex will not be "burdened with any of the competitive issues involving CLECs and others that the business was burdened with or at least affected by when it was part of Qwest." TR at 328 (Kennard). Mr. Kennard explained that:

> this business will have great value to consumers as a stand alone business focused exclusively on Yellow Pages and being able to develop all sorts of new products and plow revenues from those new products back into new products and create a virtuous cycle for this company that it hasn't been able to fully exploit as part of the RBOC.

Id. at 342. As an unregulated, competitive business, Dex will be able to develop new product lines[8] and improve customer service without the pressures associated with normal utility functions.

49 The fact that an independent Dex Media will enjoy advantages over a publishing business run by Qwest is not surprising, as the value of non-core assets are often maximized through

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[8] Mr. Kennard testified that Dex Media is investing in Spanish language directories as well as augmenting the online directory business. TR at 328 (Kennard).

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a spinoff to a company not affiliated with the BOC. *See* Exh. 241 (Kennard Direct) at 9 (describing value of spinning off assets such as wireless towers, billing services and customer care sectors). In these cases, the new owners can focus exclusively on growing and developing the value of those assets, which is a luxury the BOC does not have. Instead, the BOC must focus on the provision of local exchange and exchange access telecommunications services. Production of the Yellow Pages is not something that the BOC must do to comply with its regulatory requirements, and therefore, it is something that may attract less of the utility's attention and resources. Dex Media, on the other hand, is focused solely on providing high quality White and Yellow Page directories to the broadest range of Washington consumers. Those consumers, who include both Qwest customers and those receiving service from other LECs, stand to benefit from innovative and expanding directory service.

b. Dex Will Continue to Publish Directories as Required by Washington Law.

(1) <u>Dex Is Both Motivated and Required to Fulfill Qwest Corporation's Regulatory Publishing Obligations.</u>

50 Ratepayers in Washington need make no sacrifice in the quality or availability of printed directories, however, to gain from the free market advantages and prospects for innovation discussed above. As several witnesses made clear, Dex Media has no plans to decrease its service to Washington State and is in fact bound to publish high-quality directories that conform to all Commission requirements. *See* Exh. 1 (Publishing Agreement, Exhibit D to the Rodney Purchase Agreement, at § 3.1(b)). As Mr. Kennard testified:

> the publishing agreement makes clear that we have to fulfill Qwest's obligations to publish . . . consistent with your rules and regulations. And as a practical matter, we have every interest in doing that, because that's the core of our Yellow Pages business, so we would have no interest in not fulfilling that.

TR at 341-42 (Kennard); *see also* TR at 603 (King) ("there's a whole string of penalties that the Commission can impose" if Dex Media fails to publish directories that conform to

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Qwest Corporation's obligations in Washington); TR at 497-98 (Koehler-Christensen) (publishing agreement requires Dex Media to continue to publish directories at no cost to customers).

(2) The Interests of CLECs in Directory Listings Will Be Protected.

51 Dex Media's obligations to the CLECs in Washington will not be affected by the transfer of assets. As noted above, the regulations that currently apply to Qwest Dex will similarly bind Dex Media. Ms. Koehler-Christensen testified that the CLECs' current contracts with Dex mirror Qwest's agreement with Dex. The new publishing agreement associated with the Dex Media transaction also follows the format of these contracts, meaning that no noticeable change in publishing should be expected. *See* TR at 465-66 (Koehler-Christensen). Moreover, it is in Dex Media's best interest to continue to serve each of the CLECs in Washington and their separate customer groups. More than 25 percent of the listings in Dex Primary Directories are for customers whom Qwest does not currently provide telephone service. *See* Exh. 131 (Koehler-Christensen Rebuttal) at 18.

52 By listing directory information for non-Qwest customers and distributing directories broadly across the state, Dex Media can offer more exposure for its advertisers and more listings for its customers. These incentives remain unchanged after the sale. *See* Exh. 241 (Kennard Direct) at 8 ("As an independent publisher, we have an incentive to be even-handed in our treatment of all carriers.").

(3) The Current Practice of Publication of Government Pages Will Not Change as a Result of the Sale.

53 Finally, although a government section, or "Blue Pages" is not a regulatory requirement, Dex Media has no plans to cease publishing the government listings or other sections currently appearing in Washington directories. This concern was addressed directly by Mr. Kennard who testified that "Dex Holdings will continue to include the government listings, community information, and other features on which directory users have come to

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rely." Exh. 241 (Kennard Direct) at 7. DOD, the party who raised this issue, has agreed to the Settlement and no longer views that as a concern.

c. The Sale Does Not Affect the Commission's Ability to Impose Obligations on Qwest to Ensure That Customers Receive the Best Service.

54 Although the sale removes the publishing assets from the corporate family of the regulated utility, Dex Media will still be subject to Washington state directory publishing requirements. Should Dex Media falter in its obligations to Washington ratepayers, the Commission can seek enforcement of those obligations against Qwest, which can then look back to Dex Media for resolution. Mr. Kennard made clear that Dex Media will:

> become an affiliate of Qwest for purposes of fulfilling these obligations. And you have, if for some reason those obligations are not fulfilled, I think your recourse is to Qwest directly, over whom which you have jurisdiction. I'm not suggesting that you have jurisdiction over Dex Holdings. I'm suggesting that Qwest remains accountable for fulfilling those obligations.

TR at 344 (Kennard). This accountability flows from strong penalty clauses in the Publishing Agreement up to termination of the agreement as to directories that fail to meet regulatory requirements. *See* Exh. 1 (Publishing Agreement, Exhibit D to the Rodney Purchase Agreement, at § 6.2(b). In addition to fulfilling current obligations, if this Commission issues new regulations, Dex Media would be required to publish directories that enable Qwest to comply with any additional mandates. *E.g., id*. at § 3.1(b), WA 000714.

d. Customers, Shareholders, and the Broader Public All Benefit From Avoiding a Qwest Bankruptcy.

55 Throughout this case there has been little serious question that it is in the interests of customers, shareholders, and the broader public alike for the Commission to give Qwest every opportunity to avoid bankruptcy. Ratepayers want to avoid bankruptcy because they are generally relegated to a status below creditors and any distribution likely would not extend to their relatively low priority level. *See, e.g.* TR at 751 (Mabey). Shareholders

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obviously wish to avoid bankruptcy because they are moved to the back of the priority line. *See* Exh. 211 (Mabey Rebuttal) at 5. Finally, the public has an interest in a solvent Qwest because of potential issues such as impairment of access to necessary capital, disruption of service, or the jurisdictional confusion caused by bankruptcy. Mr. Kennard described his personal experience and frustration with trying to regulate carriers in bankruptcy:

> when I was chairman of the FCC, I lived through some bankruptcies of telecom companies, and it is pretty devastating from a regulatory standpoint, because you lose control, and the jurisdiction is transferred to the bankruptcy court. We had a lot of experience during that era with a company called Next Wave, which was a large wireless carrier that went bankrupt, and we had to convert about a third, as I recall, of our Staff in the general counsel's office became bankruptcy experts, and it was a huge diversion of our staff resources to dealing with the bankruptcy law.
>
> In discussions I have had with my successor, Michael Powell, he frequently bemoans the fact that running the FCC in an environment where a lot of the companies that you regulate are in Chapter 11 makes it difficult to do your job, because you've got quality of service issues, you've got government contracting issues that are at stake when a company goes into bankruptcy. So it is not – it's just not a healthy scenario. That's why I was – I thought it was remarkable that Staff in this proceeding suggested that bankruptcy would be a viable alternative and, in fact, a preferable alternative to allowing Qwest to solve its financial problems through this transaction.

TR at 353-54 (Kennard). Concerns about bankruptcy were also reflected in the testimony of the Department of Defense's witness, Charles King:

> My concern is that a bankruptcy judge would take one look at the Dex operation and say this is a valuable piece of property, and I think I'm going to sell it to pay the creditors, and the bankruptcy court sells Dex and we are left with nothing for ratepayers. That, I think, is the big concern I have with bankruptcy.

TR at 597-98 (King). A Qwest bankruptcy would create not just uncertainty for ratepayers and investors, but also regulatory confusion stemming from the overlap in jurisdictions between this Commission and the bankruptcy court. *See* TR at 741 (Mabey) ("While you have control of your company now, if you put it in bankruptcy, you might lose control."). Avoiding this situation is in the best interest of ratepayers, investors and the general public.

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e. The Settlement Is a Reasonable Balancing of Competing Interests.

56 A broad coalition of parties, including representatives of consumer interests, business interests, seniors, the military and military families, Qwest, and Dex Holdings, have all reached consensus that the Settlement properly balances the competing interests at stake. The Commission's primary constituency, Washington ratepayers, receives a substantial revenue credit while the public benefits from enhanced competition and high quality directory service.

(1) Washington Ratepayers Receive Significant Gain on the Sale.

57 The Commission and the Washington Supreme Court have concluded that ratepayers have a compensable interest in the sale of assets such as the Dex publishing business. *See U S West Communications v. Washington Util. & Transp. Comm'n*, 134 Wn.2d 74, 102, 949 P.2d 1337, 1352 (1997); *see also WUTC v. U S West Communications, Inc.*, Dkt. UT-950200, Fifteenth Supplemental Order at 41 (Apr. 11, 1996). To comply with these requirements, the parties have structured the Settlement to provide Washington ratepayers with the lion's share of the gain on the Dex assets. When valued as a revenue credit, the Settlement is worth at least $1.2 billion to Washington ratepayers. *See* TR at 764-65 (Kalt). Thus, the Settlement arguably shares the entire Washington portion of the gain with Qwest's ratepayers based on most parties' gain calculations and shares the vast majority of the gain even based on the Staff's inflated "phantom" calculation of the gain. *Compare* Exh. 13 *with* Exh. 334C/HC.

(2) The Timing and Structure of the Sharing Contemplated in the Settlement Balance the Competing Interests.

58 The revenue credit component of the Settlement replaces the prior imputation regime with credits of more than $100 million a year for a 15-year period. Exh. 2, § III.C.2. This serves ratepayer interests in several ways. **First** the Settlement distributes the gain over a reasonably short period, creating greater certainty that the ratepayers will receive the full

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benefit, rather than having payments stretched over a long period of time, the sustainability of which might be in doubt. **Second**, although the revenue credit is distributed in a relatively short time, the credit is not so front-loaded in the first few years (as the Staff would prefer) so as to cause an adverse financial impact that would hamper Qwest's efforts to avoid bankruptcy. **Third**, the Settlement is an attractive choice because it preserves the rate effects of the current imputation, by creating a revenue credit roughly equal to the imputation figure as it would stand today. *See* TR at 607-08 (King), TR at 1063. This avoids the need for a rate case in the near future. TR 1288, 1307-08 (Brosch). **Fourth**, the resolution embodied in the Settlement brings certainty to the long-standing question of the exact value of the ratepayer interest in Dex. This end to uncertainty concludes with a substantial immediate and multi-year payout to Washington ratepayers.

59 In essence, the revenue credit provision strikes a balance between the risks associated with short term payouts with the risks of uncollectible payments over a long period. *See* TR at 776-77 (Kalt) (balancing short and long-term risks).

f. The Settlement's Share to Ratepayers Is Consistent With, and Significantly Better Than, the Settlement the Commission Approved in the Only Other Case to Deal With the Sale of a Directory Publisher.

60 The Commission has reviewed one other sale of a directory publishing business and, under much less beneficial conditions for ratepayers, approved the ratemaking adjustment to compensate them for that sale. In 1985, Continental Telephone Company of the Northwest, Inc.'s ("CTNW") parent company, Contel Corporation ("*Contel*"), sold its subsidiary, Leland Mast Directory Company ("Leland Mast"), to Southwestern Bell. *See* Exh. 409, *Washington Utils. v. Transp. Comm'n v. Continental Tel.*, Cause No. U-87-640-T, Fourth Supplemental Order (Oct. 26, 1987), at Bates No. CONTEL-0018 (Exhibit A to Exhibit 1 to the Commission's Order). In that case, the Commission approved a Settlement executed by

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Staff, Public Counsel, and CTNW that resolved a variety of issues, including distribution of the gain resulting from the Leland Mast sale.

61 In the *Contel* case, the Commission authorized an amortization of the gain over only a five-year period, as a reduction to operating income. Exh. 291C (Brosch Direct) at 83; Exh. 409 at Bates No. CONTEL 0018. This appears to have been a straight-line amortization with no interest rate or return used in calculating the annual adjustment. There was no rate base impact and, as such, no return requirement imposed on the unamortized portion of the gain. Exhibit 409 at Bates No. CONTEL 0018. There is also no indication that, unlike here, ratepayers received any upfront cash distribution or credit from CTNW, Contel, or any other entity involved in the transaction.

62 Ratepayers received much less in the way of benefits in the *Contel* case than will be realized here should the Commission approve the Dex sale and associated Settlement. The sum of ratepayer credits under the Settlement is over $1.6 billion, which is in excess of any party's calculation of the Washington share of the gain. TR at 849-50 (Selwyn's) (calculating value of Washington regulatory asset as greater than Washington share of realized sale price). Thus, there is an implicit payment of interest or return to Qwest's ratepayers that was not included in the *Contel* settlement. Comparison with the *Contel* order is a further indication that the Settlement is well within the range of reasonableness in balancing the ratepayers' interests against competing interests.[9]

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[9] Staff has successfully kept all but the bare bones facts regarding the Commission's treatment of the Contel sale out of the record. Of course, Dex Holdings recognizes that every proposed settlement needs to be reviewed based on the individual facts and circumstances supporting it. However, the fact that the Commission has approved a settlement that provided less compensation to the shareholders should rationally be viewed as some indication that this Settlement could also be approved as being in the public interest.

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g. Legal Precedent Supports the Division of Gain Between Ratepayers and Investors.

63 The Settlement balances the interests of ratepayers and investors by distributing a significant percentage of the gain on the Dex assets to Washington ratepayers while returning the remainder of the gain to investors, who have borne the risk of loss on the directory assets as well as bearing the financial burden of the directory activities. This allocation is supported by the holding of *Democratic Central Committee of D.C. v. Washington Metropolitan Area Transit Commission*, 485 F.2d 786, 807 (D.C. Cir. 1973) ("*DCC*"). In *DCC*, the Court of Appeals for the D.C. Circuit established a two-part test to determine who should benefit from any gain on the sale of a utility asset. This test was later summarized as follows:

> such increases are to be allocated under a two-step test in which the court first asks which party "bears the risk of loss" on the assets. The party that bore the risk of loss is the party entitled to the capital gains on the assets. Only if it is difficult to determine who bore the risk of loss will "the second principle come[] into play, namely, that those who bear the financial burden of particular utility activity should also reap the benefits resulting therefrom.

Illinois Pub. Telecomms. Ass'n v. FCC, 117 F.3d 555, 569 (D.C. Cir.) (citations omitted), *clarified*, 123 F.3d 693 (D.C. Cir. 1997). Under this test, Washington ratepayers are entitled to *less* than they will receive as a result of the Settlement.

(1) Ratepayers Have Not Borne the Risk of Loss.

64 The right to capital gains on the sale of utility assets is tied to the risk of capital losses on those same assets. Investors are sometimes asked to bear the risk of such losses caused by "damage from acts of nature and man" or "loss from premature retirement . . . because of obsolescence." *DCC*, 485 F.2d at 807. However, investors are typically "denied capital gains realized on disposition of utility assets where they have not borne the risk of loss associated with the holding of such assets." *Id*. In this case, Washington ratepayers have

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not borne the risk of capital loss on the directory publishing assets for two important reasons.

65 First, the directory business began several decades before Washington began to regulate telephone service. *See* Exh. 101 (Grate Direct Testimony) at 9. This means that the telephone company initially had no entitlement to recover its costs from Washington consumers. If the directory business was not profitable – which in fact it was not for many years – the company had no state authorization to pass those costs onto its customers.[10] If the entire directory business had been lost as a result of some unforeseeable event, none of that loss would have been borne by Washington customers.[11] The same holds true for the years since 1983, when divestiture took effect. Thus, for half of Qwest's[12] 120-year life, ratepayers have borne no risk of loss. Those 60 years are especially important because they represent both 1) the initial years of directory business when it was most risky and untested; and 2) the last twenty years during which technological change has significantly altered the ability of other companies to compete in the directory business. *See* Exh. 101 (Grate Direct) at 21.

66 Second, the majority of the value of the Dex publishing business is contained in assets that have developed over time as part of the directory business – namely its customer relationships – or from assets such as the Dex trademarks that were not in existence as of 1983. *See* Exh. 242C (Kennard Rebuttal) at 10-12; Exh. 243 (FAS 141 Report) at 2. These trademarks and relationships are *not* a product of Dex's relationship with the LEC and their

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[10] For an explanation of why the Commission's 1916 and 1919 rate orders did not impose the risk of loss on consumers, see Exh. 101 (Grate) at 12-18.

[11] *See* Note 10, *id*.

[12] For simplicity, the predecessor companies that provided telephone service in Washington will not be individually named but referred to merely as Qwest.

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value should not be attributed to the ratepayers in a sale.[13] As to the customer relationships, Dex developed them as part of its effort to run a profitable directory business and their success is a measure of individual hard work rather than any association between Dex and the regulated utility. The relationships are not capital assets whose value might have to be replaced by ratepayers as a result of a catastrophic loss.

67 In Mr. Grate's words, "the regulatory scheme in Washington has <u>never</u> put ratepayers at risk for compensating owners for capital losses on their intangible assets. Consequently, under the principles of *DCC* and *IPTA*, ratepayers have no claim on the gain from these assets, which are indisputably the source of the gain in this transaction." Exh. 110 (Grate Rebuttal) at 29-30.

(2) <u>Ratepayers Have Not Borne Financial Burden.</u>

68 Only upon a determination that it is difficult to determine which party bore the risk of loss, does the second step of the *DCC* gain allocation test come into play. In this case, the evidence suggests that ratepayers have shouldered little or none of the risk of capital loss. Nonetheless, should the Commission analyze the second step, it is clear that ratepayers have never borne the financial burden of the directory publishing business. Mr. Grate pointed out that "none of the opposing parties argues that ratepayers actually bore the financial burden of the Company's directory operations." *Id.* at 23. Instead, the witnesses for the Staff argue that the ratepayers would bear the risk of declines in imputation or the risk of operating losses. *Id.* In essence, what is at stake for the ratepayers was the chance that the unregulated directory business might become less profitable and the amount of imputation would decline, moving rates closer to the actual costs of the regulated activity. However, the ratepayers have never paid money to support the directory business – indeed

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[13] The Staff's witness, Dr. Selwyn attributed 100% of the gain on the sale to Dex's relationship with Qwest. Yet Dr. Selwyn performed no quantitative analysis to support his attributions of value. *See* TR at 889-91, 908, 911 (Selwyn).

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it has been profitable since the Commission began to regulate telephone service. During that time, ratepayers have constantly enjoyed a subsidy from a business that, had it experienced losses, the ratepayers would still not have had to support. *See* Exh. 261C (Kalt Rebuttal) at 21.[14]

69 Under the second part of the *DCC* test, the gain from the transaction should accrue to the company, not the ratepayers. Nonetheless, the parties have proposed a Settlement by which ratepayers enjoy fifteen years of revenue credits set at the amount of the current imputation.

70 This Commission used *DCC* rationale to allocate between shareholders and ratepayers the proceeds received by several investor-owned electric utilities from the sale of their interests in the Centralia Coal-Fired Power Plant. *Centralia* at ¶¶ 78-86. Under the risk and burden analysis required by DCC, Washington electric consumers were exposed to much greater risks of capital loss and subject to larger financial burdens associated with the power plant operations and the potential loss of the plant than the nominal, if any, capital risks and financial burdens faced by Qwest's ratepayers regarding Yellow Pages business. Regardless, the Commission found the sale of Centralia in the public interest and ordered an even allocation of the sale proceeds (a) 100 percent to shareholders up to net book value; (b) 100 percent to ratepayers of the remainder up to original cost, and (c) 50 percent to shareholders and 50 percent to ratepayers of appreciation above original cost. *Centralia* at ¶¶ 78-86, 149, 151, 154, 156, 158-59. Given that most of the Dex gain is related to the appreciation component, Qwest could argue for more of an even split of the gain between ratepayers and investors using the *Centralia* precedent. Qwest has not, however, chosen to do this. Rather, Qwest agreed in the Settlement to provide ratepayers with a much larger

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[14] This is true notwithstanding Dr. Selwyn's belief that the Commission would have required captive ratepayers to support a money-losing Yellow Pages business. TR at 971 (Selwyn). Such a result would have undoubtedly led to a disallowance of the losses as required by Washington law. *See* RCW 80.36.300(4).

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share of the Dex sale proceeds relative to the proportion received by the electric ratepayers from the Centralia sale, despite ratepayers being exposed to much less capital, risks, and financial burdens associated with Yellow Pages. *Centralia* provides further support of the reasonableness of the Settlement.

h. Analysis of the Assets Being Transferred Suggests That the Settlement is an Advantageous Result for Ratepayers.

71 The proposed Settlement provides a balancing of interests between ratepayers and investors that is an equitable result considering the nature of the assets being sold and their history. The Staff's suggestion that ratepayers should receive a credit equal to 100% of the gain on the sale of the directory assets plus interest on the deferred portion ignores the history of the publishing business and the particular assets being transferred. *DCC* makes clear that the two-step analysis should focus on an "examination of the history *of the questioned assets*, the allocation and burdens and the accrual advantages associated with the holding of *those assets*, and thereafter a balancing of the respective interests competing for the gains at stake." *DCC*, 485 F.2d at 811-12 (emphasis added). The Staff should not be allowed to commingle the directory assets and the rest of Qwest's regulated activities for purposes of the gain allocation. Unlike the rest of Qwest's activities, the business being sold has not been protected from risk by cost-of-service regulation and has yet still managed to subsidize the rates paid by Washington customers. Exh. 261C (Kalt Rebuttal Testimony) at 21. There is no injustice in transferring the assets to an unaffiliated entity and returning fifteen years of continued revenue credits to those same customers who have never experienced, nor even been exposed to the risk of, a serious downside.

3. <u>*Centralia* Factor 3: The Sale Has a Positive Effect on Competitive Markets.</u>

72 The third prong of the Centralia public interest test examines the effect of the transaction on competitive markets. This has been interpreted to mean that the "transaction, with conditions required for its approval, should not distort or impair the development of

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competitive markets where such markets can effectively deliver affordable, efficient, reliable, and available service." *Colstrip*, Docket No. UE-990267, Third Supplemental Order at 9-10 (Sept. 30, 1999). This goal is consistent with federal policy and the public policy of the state of Washington to foster the development of competitive local telecommunications markets. Imputation of directory revenue to Qwest as a means to keep local exchange rates below the level at which they would otherwise be inhibits the efficient development of local competition and, as an implicit subsidy mechanism, is ultimately unsustainable in a competitive environment. *See*, *e.g.*, 47 U.S.C. § 251(c), 254; *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999); *Federal-State Joint Board on Universal Service*, Report and Order, 12 FCC Rcd 8776, 8786-87 (1997), *aff'd in part*, *rev'd in part*, *and remanded in part sub nom. Texas Office of Pub. Util. Counsel v. FCC*, 183 F.3d 393 (5th Cir. 1999).[15]

73 The Settlement in this case promotes the development of competitive markets by ending competition-skewing imputation. Under the agreement, imputation will be replaced by fifteen years of revenue credits which will decline, levelize, then end, placing all carriers on an even footing to compete for Washington customers. Dr. Kalt testified about the effect of imputation under the current regime:

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[15] At the state level, the WUTC has repeatedly cited the lack of CLEC complaints to dismiss Qwest's claims that imputation hampers competition. *E.g.*, *WUTC v. U S West Communications, Inc.*, Dkt. UT-950200, Fifteenth Supplemental Order at 40 (Apr. 11, 1996); *In re U S West Communications, Inc.*, Docket UT-980948, Fourteenth Supplemental Order, Order Denying Petition at ¶ 183 (July 27, 2000). The Supreme Court noted the lack of any antitrust challenges by competitors to Qwest. *U S West*, *supra*, 134 Wn.2d at 99. However, the lack of complaint is not the same as approval. The Commission should not read too much into CLECs' unwillingness to expend precious resources and political goodwill trying to increase their competitor's retail rates. There was no indication that CLECs supported imputation in either case. Nor is the lack of an antitrust case meaningful, given that Qwest is compelled by state action to impute, meaning the practice is likely immune from attack. *E.g.*, RCW 19.86.170 ("Nothing in this chapter shall apply to actions or transactions otherwise permitted, prohibited or regulated under laws administered by the . . . Washington utilities and transportation commission").

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> Policies supporting price reductions that are only for telecommunications consumers/ratepayers who remain with the ILEC and that are funded with revenues garnered from services purchased by others (e.g., directory advertisers) are not competitively neutral and portend continuing un-leveling of the competitive playing field in the ILEC's favor. This cannot have a positive impact on the development of competition and the dynamism of the competitive process.

Exh. 261C (Kalt Rebuttal Testimony) at 12 (footnote omitted). Mr. Kennard, the former Chairman of the FCC, concurred:

> I mean because really what you have right now is you have an artificial subsidy that's artificially subsidizing the rate base because of this asset. And I think it's a real subsidy. I mean this imputation of $100 Million plus does affect the ability of competitors to offer competitive rates to Qwest. And so that's why as, putting on my policy maker hat, I think there's a huge benefit of taking this asset out of the RBOC and ending this imputation, giving fair value to the rate payer, which I think the public counsel settlement does, and ending that artificial subsidy in the rate base.

TR at 328-29 (Kennard). The imputation subsidy provides the incumbent LEC with assumed income that serves to keep rates down in a competitive marketplace. Gradually ending this subsidy will encourage long-term competition among LECs in Washington and the benefits of such competition will accrue to Washington ratepayers.

74 Finally, the sale and Settlement are consistent with the fundamental purpose of the *MFJ*: the Agreement will promote competition among local exchange services by preventing the ILEC consumers from enjoying subsidized rates while customers of other local exchange providers pay a higher rate. *See*, *e.g.*, Exh. 261C (Kalt Rebuttal) at 12-13 (providing price reductions, funded by directory publishing revenue subsidies, for ratepayers who remain with the ILEC is anti-competitive and contrary to the Washington public's long-run interests).[16]

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[16] Indeed, evidence presented in a recent FCC proceeding involving Section 271 of the Act demonstrates that the local exchange market in the Company's service area is fully open to competition. *See Comments of the Washington Utilities and Transportation Commission, Qwest Section 271*, WC Docket No. 02-189, at 3 (filed July 29, 2002) (concluding that Qwest had demonstrated the presence of facilities-based competition in the local exchange market in Washington).

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4. <u>*Centralia* Factor 4: Protection of the Interests of Washington Ratepayers</u>

75 Under the decisions of the Commission and the Washington Supreme Court it is fundamental that Qwest's ratepayers are entitled to receive a **fair share** of the **fair value** of the directory business. Since the Settlement accomplishes both of those requirements, it protects the interests of Qwest's ratepayers. Yet both the Settlement and the Commission's test from *Centralia* provide more. Under *Centralia* the test is the benefit to *all* ratepayers, not just Qwest ratepayers. Because the Settlement provides pro-competitive benefits, as discussed above, it ultimately benefits ratepayers of Qwest's competitors as well.

76 It is important to note that Qwest's ratepayers do NOT have an interest in never ending, always increasing imputation. That status quo could never have been maintained forever and, in fact, as discussed above, has already evolved past the point at which imputation fully protects ratepayer interests. Accordingly, the Settlement protects the ratepayer's legitimate interests, even though it phases out the subsidy of local phone rates at the end of 15 years.

a. The Arms' Length Sale Produced Fair Market Value for Qwest Ratepayers to Share.

77 The Commission's ratification of the Settlement would also be consistent with a principle it has insisted upon during the last twenty years: an arms' length sale of the directory publishing business for fair market value. An evaluation of the sales process and the purchase price reveals that the auction of the Company's directory publishing business to Dex Holdings LLC is representative of an arms' length transaction achieving fair market value.

78 The Qwest Dex sale was conducted in a manner to ensure competition among rival purchasers: an extended auction process involving multiple bidders, rejected offers, and significant pricing pressures all evidence a fair market value transaction. *See, e.g.*, Exh. 261C (Kalt Rebuttal) at 8-9 (highlighting characteristics of the QwestDex sale that are

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indicative of a fair market value transaction).[17] Indeed, the evidence of a fair market transaction is indisputable: the auction of Qwest Dex was widely advertised to a group of potential buyers; thirty-nine parties signed a confidentiality agreement and received descriptive information; several independent purchasers formed bidding consortiums; bidders undertook due diligence of the company; and, some bidders dropped out as the price of the asset presumably exceeded their willingness to pay. *See, e.g.*, Exh. 242C (Kennard Rebuttal) at 2-6 (detailing the competitiveness of the bidding process for the Company's directory publishing business and highlighting the fact that "bidders included several of the largest and best-funded private equity firms in the world"); Exh. 221C (Taylor Rebuttal) at 11-13 (describing the Qwest Dex sales process); *see also* Exh. 291C (Brosch Direct) at 20 ("In contrast to the contrived affiliate transactions in the 1980's, the pending Dex sale is a true sale of the directory business for a negotiated cash price determined through interaction of informed parties in possession of relevant valuation information.").

79 The auction sales process employed by the Company resulted in an approximately $7.05 billion purchase price for the directory publishing business. By definition, this price is indicative of fair market value.[18] The fair market value of a particular asset is not a mathematically precise dollar amount which can be calculated in the abstract, but rather is any amount within an acceptable valuation range:

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[17] Indeed, Lehman Brothers and Merrill Lynch, renowned investment banks acting as the Company's advisors in connection with the sale of Qwest Dex, confirmed that the sale of the directory publishing was financially fair. *See*, *e.g.*, Exh. 178 (Cummings Rebuttal) at 12-13 (explaining that the sale was a fair market transaction which engaged multiple competitive bidders).

[18] "Fair market value" is the "price that a seller is willing to accept and buyer is willing to pay on the open market and in an arm's-length transaction." *Black's Law Dictionary* 1549 (7th ed. 1999); *see also* Exh. 261C (Kalt Rebuttal) at 5 ("[F]air market value is the value of a good or service, or, as in this case, a business obtained when it is sold in open commerce between a willing buyer and a willing seller under competitive circumstances.").

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> [T]he value of Qwest Dex is expressed explicitly as a range. This is consistent with the basic economics of valuation. Every estimate of value has a confidence interval or range of values associated with it (explicitly or implicitly). This is the necessary result of the uncertainty surrounding how the market will value any particular asset, stemming from unknown future market conditions, uncertainty surrounding cash flow forecasts for the company, uncertainty regarding risks, etc. Because of these uncertainties, it is not possible as a matter of economic logic to provide an estimate of fair market value that does not explicitly include a range of values such that a transaction value within that range reflects fair market value.

Exh. 261C (Kalt Rebuttal) at 10-11. Not only was the price paid by Dex Holdings LLC a result of a competitive bidding process, the purchase price falls within the valuation ranges prepared by the Company's investment bankers, providing additional assurance that the result reflects fair market value. *See*, *e.g.,* Exhibits 316C-19C.

b. The Ratepayers Are Not Entitled to Never Ending Imputation and Qwest is Entitled to Sell Dex.

80 The Commission has already recognized that an arms-length sale would likely produce a fair market valuation of Dex and that such a sale should end Dex's involvement in Qwest Corporation ratemaking:

> If . . . PNB and [US West Direct] intended a permanent transfer of the yellow pages, treatment as a sale may be most appropriate. Such treatment would allow for determination of consideration at the time of transfer that would fairly compensate PNB. . . . Such a result is appropriate if US West Direct seeks to ultimately acquire all of the opportunity for profit. Treatment as a sale is very likely to reflect a result that might have been achieved by parties bargaining at arms length. Also, no further supervision by this Commission of the publishing enterprise of an unregulated company would be necessary if the transaction is treated as a sale. US West Direct would be free to manage its business without involvement in future proceedings concerning the proper levels of compensation to PNB. PNB would have the reasonable value of its asset.

In re Pacific Northwest Tel. Bell Tel. Co., Cause No. U-86-156, Second Supplemental Order, at 12 (Oct. 11, 1988); *see also U S West*, 134 Wn.2d at 89, 949 P.2d at 1345 (explaining that the Commission's 1988 Second Supplemental Order mandated that "a fair contract between the Company and its affiliate for the sale of the assets would put an end to

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any imputation of revenue"). Indeed, when the Washington Supreme Court upheld the Commission's authority to require imputation, it explicitly noted that the practice was not permanent. The court explained that imputation was merely an interim remedy, fashioned to ensure that the Company received fair market value in its sale of the asset to its affiliate. "[I]mputation is not necessarily permanent, and the Commission's prior orders show that **when the Company has shown it has received fair compensation from its affiliate for the value of the asset it transferred, imputation may cease.**" *Id.* at 102, 949 P.2d at 1352 (emphasis added).

81 In the present transaction, the Company has not only *sold* – rather than transferred – the directory publishing business, but it has conveyed the asset to a *wholly unaffiliated* entity, Dex Holdings LLC. As detailed in Section III.C.4.a., *supra*, conclusive evidence establishes that the sale of Qwest Dex was conducted through an arms' length transaction that achieved fair market value for the asset. The Commission's sole basis for requiring imputation no longer exists. Moreover, continuing to maintain the anachronistic practice will actually harm the public interest by distorting competition among local exchange carriers. *See*, *e.g.*, Exh. 261C (Kalt Rebuttal) at 13-14 (detailing the harmful consequences of continuing imputation).

IV. CONCLUSION

82 The Settlement brings significant and almost certain benefits to ratepayers. As the alternative, Staff offers the status quo indefinitely. That alternative is, at best, subject to numerous risks and based on speculative assumptions. At worst, following the Staff's recommendation would lead to the disastrous result for ratepayers of a complete loss of imputation and any gain on the sale of Dex. Evaluating the broad and long-term public interest is not merely a matter of comparing mathematical calculations of projections of historic revenue streams and growth trends. Ignoring the realities and the risks is fraught

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with danger. An appropriate measure of the public interest will take into account the risks and uncertainties inherent in the status quo.

83 As the Commission once said, "It is essential that the Commission allow an acceptable proposal to take effect . . . . [P]ursuit of an elusive and perhaps subjective perfection does not advance the public interest." *WUTC v. U S West Communications*, Dkt. UT-911488, Sixth Supplemental Order Accepting Filings, at 2 (Dec. 2, 1994). The Settlement may not meet anyone's subjective definition of "perfection." But it is "acceptable" to parties in this proceeding representing the constituencies that imputation was intended to protect. The Commission should approve the Settlement without modification to advance the public interest, rather than seeking alternatives that put the public interest at risk.

Dated this 3rd day of July, 2003.

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CERTIFICATE OF SERVICE - Docket UT-021120

I hereby certify that a true and correct copy of the foregoing was sent by e-mail and United States first class mail, postage fully prepaid, addressed to the following:

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Dated at Seattle, Washington this ______ day of July, 2003.

____
Carol Munnerlyn

*** Hand delivered by Noon**

APPENDIX A

THE COMMISSION'S CONSIDERATION OF THE IMPUTATION ISSUE

Dec. 22, 1983	Pacific Northwest Bell Telephone Company ("PNB") – a predecessor-in-interest to Qwest Corporation and US West Communications, Inc. – applies for approval to transfer its directory publishing business (as well as other assets) to an unregulated affiliate, Landmark Publishing Company ("Landmark"). The Commission, expressing concern that PNB could undervalue directory advertising revenues earned by Landmark, expressly reserved the right to determine reasonable revenues and expenses of the directory publishing business in any formal rate-making proceeding. *See In re Pacific Northwest Telephone Bell Telephone Co.*, Cause No. FR-83-159, Order Granting Application, in Part, at 2 (December 30, 1983);
Jan. 16, 1985	PNB seeks Commission approval to replace its initial publishing agreement with Landmark. The Commission approved the revised directory publishing agreement, but determined that the "[t]ransactions between PNB and US West Direct [its affiliate] are not arms length. The Commission's primary concern is that PNB is not undervaluing the Publishing Agreement and thereby receiving less revenue from the directory than it would if it provided the service itself." *In re Pacific Northwest Telephone Bell Telephone Co.*, Cause No. FR-83-159, Fourth Supplemental Order, at 6 (January 16, 1985).The Commission, once again, reserved decision on the reasonableness of the fees the affiliate was to pay PNB for publishing rights.
Dec. 23, 1986	PNB requests Commission approval of new publishing agreements with a Landmark subsidiary, US West Direct. While the Commission granted temporary approval of the agreements, it determined that the compensation paid to PNB by its affiliate for publishing rights was "unreasonable and not in the public interest." *In re Pacific Northwest Telephone Bell Telephone Co.*, Cause No. U-86-156, Second Supplemental Order, at 28 (October 11, 1988). Deeming the publishing fees payable to PNB under the agreements unreasonable and inadequate, the Commission ruled that it would determine the appropriate compensation payable to PNB in the next general rate case.
Dec. 20, 1988	PNB applies for approval of a revised publishing agreement with US West Communications, Inc. ("USWC"). The Commission conditionally approves the agreement, subject to a further review of publishing fees. *See In re Pacific Northwest Telephone Bell Telephone Co.*, Cause No. U-86-156, Third Supplemental Order (February 6, 1989.)
Jan. 16, 1990	Commission files a Complaint against PNB alleging excessive earnings. The parties settle the matter, and as part of the settlement, PNB stipulates to imputation of a portion of its directory publishing business revenue as company revenue for regulated services. *See Washington Utilities and Transportation Committee v. Pacific Northwest Telephone Bell Telephone Co.*, WUTC Cause Nos. U-89-2698-F and U-89-3245-P, Fourth Supplemental Order (January 16, 1990).

Dec. 7, 1989	PNB seeks Commission approval of proposed merger of PNB, Mountain Bell, and Northwestern Bell Telephone Company into US West Communications, Inc. ("USWC"). All interested parties entered into a settlement agreement whereby PNB would continue imputation until the end of 1994. The Commission conditionally approved the settlement, modifying it so that advertising revenue from the directory publishing business be imputed in perpetuity. *See In re Pacific Northwest Telephone Bell Telephone Co.*, Cause No. U-89-3524-AT, Second Supplemental Order (November 9, 1990).
Nov. 20, 1990	PNB challenges the Commission's modification of the Settlement Agreement, arguing that continuing imputation into perpetuity was inappropriate. The Commission agrees to modify the settlement agreement so that directory publishing revenues "will continue to be imputed accordingly unless and until altered by subsequent order of the Commission." *See In re Pacific Northwest Telephone Bell Telephone Co.*, Cause No. U-89-3524-AT, Third Supplemental Order, at 2 (November 30, 1990).
Feb. 17, 1995	USWC files a petition for a general rate increase and proposes that imputation be discontinued. USWC challenges imputation as an illegal practice. The Commission rejects USWC's challenge and ordered imputation of directory earnings. *See Washington Utilities and Transportation Committee v. U S West Communications, Inc.,* WUTC Cause No. UT-950200, Fifteenth Supplemental Order (1996).
Dec. 24, 1997	After USWC appeals the Commission's decision to the courts, the Washington State Supreme Court determined that the Commission possessed the statutory authority to impute directory earnings in connection with rate-making. The Court, relying on Commission precedent, expressly held that imputation could end when the directory publishing business was sold and fair compensation received. *See US West Communications, Inc. v Washington Utilities and Transportation Committee*, 134 Wn.2d 74, 102, 949 P.2d 1337 (1997) (citing *In re Pacific Northwest Telephone Bell Telephone Co.*, Cause No. U-86-156, Second Supplemental Order (October 11, 1988)).
July 27, 2000	US West again requests an end to imputation, explaining that, since 1983, PNB had received more in cumulative publishing fees than the value of the directory publishing business as it existed in 1983. The Commission denies the request and determined that PNB had never permanently transferred the directory publishing business to Landmark (or any other successor-in-interest) in 1983 or at any other subsequent time. *See In re U S West Communications, Inc.*, Docket UT-980948, Fourteenth Supplemental Order, Order Denying Petition (July 27, 2000).