BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Application of	)	DOCKET NO. UT-021120
QWEST CORPORATION	)	TENTH SUPPLEMENTAL ORDER: APPROVING AND ADOPTING SETTLEMENT AGREEMENT; GRANTING APPLICATION AND ACCEPTING NOTICE, SUBJECT TO CONDITIONS
Regarding the Sale and Transfer of Qwest Dex to Dex Holdings, LLC, a non-affiliate	)	
. . . .	)	

SYNOPSIS: The Commission approves the sale of Qwest Corporation's directory publishing business subject to conditions proposed via a partial settlement agreement. Seller, buyer, and all customer groups supported the settlement agreement. Commission Staff opposed the settlement agreement. Under the terms of the settlement agreement, Qwest Corporation is required to share the Washington portion of its gain on sale with ratepayers in the form of immediate applications of credits against customer bills totaling $67 million. Qwest Corporation also is required to book revenue credits for purposes of rates, each year for fifteen years. The revenue credits are set at $110 million for four years, and $103.4 million for eleven years. The settlement parties estimate that the net present value of the ratepayers' share of the gain on sale is $942 million.

1 **PROCEEDINGS:** Qwest Corporation filed its "Application Regarding Transfer and Sale of Directory Business and Notice of Possible Affiliated Interest Transaction" on September 3, 2002.[1] The Application and Notice

[1] Qwest Corporation (the company that provides local exchange telephone service to residential and business customers in Washington) is an affiliate of Qwest Dex, Inc. (the directory publishing business), Qwest Services Corporation, and Qwest Communications International, Inc. ("QCI"). QCI is the ultimate parent of the other three. The Application before us is by Qwest Corporation, on behalf of itself and its three affiliates. We collectively refer to the four companies as "Qwest."

request Commission approval of the permanent transfer and sale of the Qwest Dex directory publishing business and associated assets to Dex Holdings, LLC, which is not affiliated with Qwest. On May 16, 2003, Qwest Corporation filed a "Stipulation and Settlement Agreement"—a partial settlement opposed by the Commission's regulatory staff[2] ("Commission Staff" or "Staff") but supported by all other active parties.[3] The Commission conducted evidentiary hearings on May 19, 21-23, and 28-30, 2003. The parties filed initial briefs on July 3, 2003, and reply briefs on July 18, 2003.

2 **PARTIES:** Lisa A. Anderl, Senior Attorney, Adam Sherr, Attorney Seattle, Washington, and Philip Roselli, Attorney, Denver, Colorado, represent Qwest Corporation. Brooks Harlow and Bill Connors, Miller Nash LLP, Seattle, Washington, represent Dex Holdings, LLC. Arthur A. Butler and Lisa Rackner, Ater Wynne LLP, Seattle, Washington and Portland, Oregon, represent WeBTEC, f/k/a TRACER. Stephen S. Melnikoff, Department of the Army, Judge Advocate General, represents the Department of Defense and Federal Executive Agencies ("DoD/FEA"). Ronald Roseman, attorney, Seattle, Washington, represents the AARP. Gregory J. Kopta, Davis Wright Tremaine LLP, Seattle, Washington represents XO Washington, Inc. Simon ffitch and Robert Cromwell, Assistant Attorneys General, Seattle, Washington, represents the Public Counsel Section, Office of Attorney General ("Public Counsel"). Greg Trautman and Shannon Smith, Assistant Attorneys General, Olympia, Washington, represent Commission Staff.

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[2] In formal proceedings, such as this case, the Commission's regulatory staff functions as an independent party with the same rights, privileges, and responsibilities as any other party to the proceeding. There is an "*ex parte* wall" separating the Commissioners, the presiding ALJ, and the Commissioners' policy and accounting advisors from all parties, including Staff. *RCW 34.05.455*.

[3] Public Counsel, AARP, DoD/FEA, Dex Holdings, LLC, and WeBTEC all are signatories to the settlement agreement. XO Washington elected not to participate, but does not oppose the settlement.

3 **COMMISSION:** The Commission, considering the fully developed evidentiary record in this proceeding, approves and adopts the partial settlement agreement as a reasonable resolution of the pending issues. The Commission grants Qwest's Application and accepts its Notice.

MEMORANDUM

I. Background and Procedural History.

A. Procedural History

4 Qwest Corporation filed its "Application Regarding Transfer and Sale of Directory Business and Notice of Possible Affiliated Interest Transaction" on September 3, 2002. The Commission held its first prehearing conference before Administrative Law Judge Dennis J. Moss on October 8, 2002. The Commission established a procedural schedule.

5 Qwest and Dex Holdings, Inc., filed their direct cases on January 17, 2003. Qwest filed testimony and exhibits sponsored by five witnesses: Mr. George A. Burnett, CEO, Qwest Dex, Inc.; Ms. Theresa A. Jensen, Senior Director of Washington Regulatory Affairs, Qwest Corporation; Mr. Philip E. Grate, State Finance Director, Qwest Corporation; Mr. Brian G. Johnson, consultant; Mr. Peter C. Cummings, Director-Finance, Qwest Corporation. Dex Holdings, Inc., filed testimony sponsored by Mr. William E. Kennard, Director, Telecommunications and Media Group, The Carlyle Group.

6 Other parties filed their response cases on March 18, 2003. Public Counsel, joined by AARP and WeBTEC, filed testimony and exhibits sponsored by Mr. Michael L. Brosch, consultant. DoD/FEA filed testimony and exhibits sponsored by Mr. Charles W. King, consultant.

Commission Staff filed testimony and exhibits sponsored by three witnesses: Dr. Lee L. Swelyn, consultant; Dr. Glenn Blackmon, Assistant Director of Telecommunications, WUTC; and Ms. Kathleen M. Folsom, Senior Telecommunications Regulatory Analyst, WUTC.

7 On April 17, 2003, Qwest filed rebuttal testimony and exhibits by Mr. Grate. In addition, Qwest filed rebuttal testimony and exhibits sponsored by Mr. Mark S. Reynolds, Senior Director, Washington Regulatory Affairs, Qwest Corporation, who also adopted portions of Ms. Jensen's prefiled direct; Ms. Ann Koehler-Christensen, Regulatory Finance Analyst, Qwest Corporation; Peter C. Cummings, Director-Finance, Qwest Corporation, who also adopted portions of Mr. Johnson's testimony; Mr. Ralph R. Mabey, Partner, LeBoeuf, Lamb, Greene & MacRae, LLP; and Dr. William E. Taylor, Senior VP, National Economic Research Associates, Inc. and; Dr. Joseph P. Kalt, Ford Foundation Professor of International Political Economy, JFK School of Government, Harvard University.

8 On May 16, 2003, Qwest Corporation filed a "Stipulation and Settlement Agreement." Public Counsel, AARP, WeBTEC, and DoD/FEA support the settlement. Dex Holdings, the purchaser, also supports the settlement. XO Washington did not participate actively in the proceedings, but does not oppose the settlement. Commission Staff opposes the settlement. Parties were afforded an opportunity to file supplemental testimony and exhibits in support of the settlement agreement. Mr. Reynolds, Mr. Kennard, Dr. Kalt, Mr. King, and Mr. Brosch all filed supplemental testimony in support of the settlement. Dr. Selwyn and Dr. Blackmon filed supplemental testimony opposing the settlement.

9 The Commission conducted evidentiary hearings on May 19, 21-23, and 28-30, 2003. The transcript of witness examination includes more than

1100 pages and reflects the admission of more than 200 exhibits. The parties filed initial briefs on July 3, 2003, and reply briefs on July 18, 2003.

B. The Transaction

10 Qwest's Application asks the Commission either to disclaim jurisdiction over the company's proposed sale of the Qwest Dex, Inc., directory publishing business ("Dex") or, to the extent of the Commission's jurisdiction, to approve the transfer and enter an order disposing of the gain on sale as provided in a partial settlement agreement filed on May 16, 2003. The proposed sale is to Dex Holdings, LLC, an entity newly formed for the express purpose of buying the directory business from Qwest for the sum of approximately $7.05 billion.[4] Dex Holdings, LLC was formed by two private investment firms, the Carlyle Group and Welsh, Carson, Anderson & Stowe. This would be the second-largest leveraged buyout in United States history. *Qwest Brief at 23.*

11 The Dex sale consists of two principal purchase agreements executed on August 19, 2002 – the so-called Rodney agreement and the so-called Dexter agreement – and numerous ancillary agreements attached as exhibits to the two purchase agreements.[5] An overview of the transaction, as included in Qwest Corporation's Application, is attached to this Order as Appendix A.

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[4] The $7.05 billion is subject to adjustment for working capital and certain final audited financial statements.

[5] The Rodney agreement encompasses Dex's operations in Washington, Arizona, Idaho, Montana, Oregon, Utah, and Wyoming. The Dexter agreement, which closed on November 8, 2002, includes Dex's operations in Colorado, Iowa, Minnesota, Nebraska, New Mexico, North Dakota, and South Dakota.

C. The Past is Prologue

12 The genesis of this proceeding rests 20 years in the past, with entry of the Modified Final Judgment ("MFJ") in *United States v. AT&T*, 552 F. Supp. 131 (D.D.C. 1982), *aff'd sub nom, Maryland v. United States*, 460 U.S. 1001 (1983). Under the that judgment, AT&T's nationwide monopoly over local telephone service ended, and the familiar "Ma Bell" gave birth to seven regional Bell operating companies ("RBOCs"). The Court required that the directory publishing function be divested to the RBOCs so that, among other things, the substantial revenues derived from yellow pages advertising would continue to be accounted for in local telephone service rates.

13 Shortly before the effective date of AT&T's divestiture of the RBOCs, Pacific Northwest Bell ("PNB") (*i.e.*, the predecessor to US West Communications and to Qwest Corporation), transferred its directory publishing operations, including employees, tangible assets, and working capital, to an unregulated affiliate, Landmark Publishing Company ("Landmark"). In December 1983, PNB applied for approval of the transfers of the tangible assets, a leasehold interest, cash working capital and publishing agreements between Landmark and PNB. The Commission approved the transfers and publishing agreements pursuant to Chapters 80.12 and 80.16 RCW. The Commission did not, however, approve the compensation associated with the transfers or publishing agreements for ratemaking purposes. Rather, the Commission reserved the right to determine reasonable revenues and expenses, together with their proper regulatory treatment, in any formal proceeding before the Commission dealing with the results of PNB's operations for ratemaking purposes.

14 The matter of the relationship between PNB and Landmark, and their successors, turned up on the Commission's docket repeatedly in subsequent years. In three orders entered prior to 1990, the Commission expressed its concern that the transactions between the telephone company and its directory publishing affiliate were not at arm's length and were characterized by inadequate compensation being paid by the publishing company. In 1989, the Commission filed a formal complaint against PNB alleging excessive earnings. The Commission resolved the proceeding on the basis of a settlement agreement in which PNB agreed to imputation of a portion of its directory publishing affiliate's revenue to its regulated affiliate's books as revenue for ratemaking purposes.

15 In a separate proceeding during 1990, in which PNB sought Commission approval of a proposed merger of PNB, Mountain Bell, and Northwestern Bell Telephone Company in to US West Communications, Inc., the Commission conditionally approved a settlement among the parties, modifying it so that advertising revenue from the directory publishing business would be imputed in perpetuity.[6] Later, the Commission entered its Order on Reconsideration providing that directory publishing revenues "will continue to be imputed accordingly unless and until altered by subsequent order of the Commission."[7]

16 In 1995, US West Communications, Inc. ("USWC") filed a petition for a general increase in rates. USWC challenged imputation as an illegal practice. The Commission rejected USWC's challenge and ordered imputation of directory publishing revenues in the amount of approximately $80 million annually, for purposes of rates. The

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[6] *See In re Pacific Northwest Bell Telephone Co.,* Cause No. U-89-3524-AT, Second Supplemental Order (November 6, 1990).

[7] *See In re Pacific Northwest Bell Telephone Co.,* Cause No. U-89-3524-AT, Third Supplemental Order (November 30, 1990).

Washington Supreme Court affirmed.[8] The Supreme Court stated, among other things, that imputation could end if and when the directory publishing business was sold and fair compensation received.

17 In July 1998, USWC again requested an end to imputation, arguing that PNB had received more in cumulative publishing fees since 1983 than the value of the directory publishing business as it existed in 1983, plus reasonable interest since that time. The Commission denied the request and determined that "the Yellow Pages publishing activity has not been transferred permanently to USWC's affiliate for regulatory purposes."[9] The Commission found that it had been asked in 1983 and later cases only to approve certain publishing agreements and transfers of certain tangible assets and cash.[10] The Commission held that it "will continue to regulate USWC as though it retains all rights to the asset."[11]

18 In addition to the Commission's historic treatment of the directory publishing business in the hands of PNB and its successor US West, Inc. (d/b/a in Washington as USWC), another salient piece of history to this proceeding is the merger of US West, Inc. with Qwest Corporation International, Inc. On August 31, 1999, US WEST, Inc., and Qwest Communications International, Inc., jointly filed an Application requesting that the Commission issue an order disclaiming jurisdiction over their proposed merger transaction, or in the alternative, approving the merger. The Commission held it had jurisdiction, and approved the

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[8] See WUTC v. US West Communications, Inc., Cause No. UT-950200, Fifteenth Supplemental Order (April 11, 1996), *aff'd, US West Communications, Inc. v. WUTC,* 134 Wn.2d 48, 949 P.2d 1337 (1997).

[9] *In re the Petition of US WEST Communications for an Accounting Order*, Docket No. UT-980948, Fourteenth Supplemental Order, ¶ 19 (July 27, 2000).

[10] *Id*, ¶¶ 169, 176, 177.

[11] *Id.*, ¶ 169.

merger, subject to the conditions included in two settlement agreements filed by the parties to the proceeding.[12]

19 When the Commission approved the merger, just over three years ago, both US West and Qwest were financially sound. Qwest, the financially dominant partner in the transaction, was governed by a Board of Directors and operated by officers who appeared to be possessed of high degrees of business acumen and integrity. The conditions the parties agreed to in the settlements that the Commission ultimately approved promised improved service quality and stable rates for Washington consumers, and generally appeared to ensure that the merger transaction would not harm the public interest, which is the standard for disapproval of such a transaction under our governing statutes and rules.[13] As we discuss in section II of our Order, subsequent events that we could not have foreseen either from the record in the merger proceeding, or in the broader context of our monitoring companies subject to our jurisdiction and the telecommunications industry generally, bring us to a very different understanding today.

II. Discussion.

A. Qwest's Current Circumstances

20 Qwest's financial condition dramatically deteriorated beginning in early 2001, just six months after the Commission approved the merger between Qwest and US West. Mr. Cummings *(Exhibit Nos. 171 and 172)* offered testimony that provides significant detail showing Qwest's rapid financial

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[12] *In Re Application Of US West, Inc., And Qwest Communications International, Inc., For An Order Disclaiming Jurisdiction, Or In The Alternative, Approving The US West, Inc.--Qwest Communications International, Inc. Merger*, Docket No. UT-991358, Ninth Supplemental Order (June 19, 2000).

[13] *See* chapter 80.12 RCW and chapter 480-143 WAC.

decline. By January 2002, QCI's financial reports showed declining earnings, declining revenues, and over $25 billion in debt on the company's balance sheets. *Exhibit No. 172 at 8.* QCI's stock price declined from the mid-$40's in January 2001 to the $10 range by the end of January 2002. *Exhibit No. 174.* By mid-February 2002, Qwest was unable to access the commercial-paper market and was required to draw down its entire $4 billion syndicated bank credit facility to meet existing commercial paper indebtedness. *Exhibit No. 172 at 10.* The bond rating agencies immediately downgraded both QCI's and QC's long-term and short-term debt ratings. *Id.* Later in 2002, following additional downgrades, the Qwest companies' bond ratings fell to "junk" bond status.

21 Qwest's problems were exacerbated in March 2002, when QCI received an informal inquiry from the Denver Regional Office of the Securities and Exchange (SEC) concerning matters involving Qwest's accounting policies and practices. *Exhibit No. 172 at 11.* The inquiry raised questions about QCI's prior financial results and future earnings. *Id.* The SEC issued a formal order of investigation on April 3, 2002. *Id.* The pending SEC investigation meant that QCI could not issue new stock or bonds to the public in a registered offering. *Id.*

22 QCI managed additional financing and negotiated an amendment to its credit facility to resolve the company's financial concerns through the second quarter of 2002. *Id. at 14.* However, QCI by then carried a debt load of $26 billion and continued to experience declining revenues and earnings. *Id.* On April 18, 2002, QCI announced that "it has decided to proceed with seeking proposals from potential buyers for its Dex (directories) and Wireless businesses and is also working on selling its Qwest Cyber Solutions business and other assets, including access lines and wireless towers." *Id. (quoting QCI Form 8-K, April 19, 2002).*

23 Qwest again negotiated amendments to its credit facility, now referred to as the ARCA (Amended and Restated Credit Agreement). *Id. at 15-16.* The ARCA established a new maturity date of May 3, 2005, but required intermediate payments before then, with specific payments tied to the sale of Dex and other assets. *Id.* According to Mr. Cummings, "[a]bsent the Dex sale, QCI would lack the necessary cash to make the required payments under the ARCA, and other upcoming maturities, including the Dex Term Loan." *Id.* Mr. Cummings testified further that, "Completion of both phases of the Dex sale is critical to providing the cash for Qwest to de-lever its balance sheet and meet its debt service obligations." *Id. at 17.* Indeed, even then QCI may not meet its debt service obligations through 2005. *Id.*

24 Mr. Cummings summarized his detailed testimony as follows:

> Qwest is facing very difficult financial times. Falling revenues, decreased cash flows, high debt, outside investigations, a collapsed stock price, and a lack of access to the commercial paper market left the company in a critical liquidity situation and approaching bankruptcy by early 2002 . . .. Qwest concluded that the sale of assets, specifically Dex, was necessary to its strategy of de-levering its balance sheet and stabilizing its liquidity situation. The Dex transaction was also critical to allowing Qwest to successfully negotiate the ARCA. Absent the ARCA, Qwest would almost certainly have been facing bankruptcy . . . The sale of Dex (both phases) remains critical to Qwest's ability to avoid bankruptcy in the short and intermediate term.

Id. at 20-21. As summarized in a later section of this Order, Commission Staff argues that Qwest exaggerates the probability of bankruptcy absent the sale of Dex.

25 Finally, and importantly, the sale of Dex has already gone forward in seven of Dex's fourteen states. Five of the remaining seven states have either approved the sale, or said that no approval is required. Washington cannot control the outcome of the overall sale in other states. To the contrary, we must take into account the sale in the other states when determining the effects on Washington. That is, we need to examine the risks of sale or non-sale in Washington, in light of action in the other states.

B. The Settlement Agreement

26 The settlement agreement is attached as Appendix B to this Order. Although the Commission adopts the settlement agreement and incorporates it by reference into the body of this Order, we excerpt from its essential terms here for ease of reference.

27 The settlement provides for an up-front payment to customers:

> During a complete billing cycle commencing not later than forty-five (45) days following the closing of the Sale (the "Billing Cycle"), Qwest shall provide bill credits totaling SIXTY-SEVEN MILLION and NO/100 DOLLARS ($67,000,000.00) to active customers of record during the Billing Cycle who currently subscribe to the **services identified in Appendix 1**. . . Qwest will provide Bill Credits in an aggregate amount of [$67 million] within seventy five (75) days after closing of the Sale." *Id. at 3-4.*

Exhibit No. 2 at 3-5. The bill credit amounts to approximately $29.87 per access line, according to calculations in Appendix 1 of the settlement agreement. *Id. at 3-5 and Appendix 1.*

28 The settlement provides for 15 years of revenue credits:

> A revenue credit of $110 million shall be added to Qwest's Washington intrastate regulated revenues beginning on January 1, 2004 and ending on December 31, 2007, and an annual revenue credit of $103.4 million (in replacement of the $110 million) shall be added to Qwest's Washington intrastate regulated revenues beginning on January 1, 2008 and ending on December 31, 2018. . . [T]he practice of imputing directory revenues to Qwest in rate cases or other rate proceedings shall cease on December 31, 2003 and . . . the annual revenue credit amounts described herein shall be instituted in place of any future directory revenue imputation calculations.

Id. at 5-6.[14]

29 Under the heading "Customer Service Guarantee Program," the settlement provides:

> As of June 30, 2003, Qwest has the right under the Merger Settlement Agreement in Docket No. UT-991358 to file tariff revisions to remove any customer-specific service quality remedy required in Sections II.A.3-7 of that Settlement Agreement, if that remedy is not required of all local exchange companies operating in exchanges in which QC operates. Those remedies are currently contained in QC's Washington intrastate tariff. WN U-40, Section 2.2.2.B, sheets 27 through 32. Qwest commits not to petition to remove those remedies for a period of two (2) additional years. The parties agree, however, that QC may seek to change certain aspects of the Customer Service Guarantee Program during this period, and Qwest commits to discuss with the parties

[14] The imputation amount currently embedded in QC's rates is about $85 million. *TR.. 1133-34, 1193-94 (Reynolds).* Qwest estimated that if it were to have a rate case during 2003, the amount would have increased to approximately $103.4 million. *Id.*

> no less than thirty (30) days in advance any changes it may seek to make and will consult with interested parties prior to filing.

Id. at 6.

30 Under the heading "WTAP Program," the settlement provides:

> To improve customer access to the Washington Telecommunications Assistance Program (WTAP) and associated benefits from the federal Lifeline and Link-Up programs, and the Tribal Lifeline/Link-Up, Qwest commits that within two months after the effective date of the settlement agreement, all Qwest service representatives answering calls from Washington customers will be knowledgeable about TAP benefits, enrollment procedures, and payment plans provided by the company consistent with Commission rules. Qwest commits to taking specific steps to ensure that its service representatives can accurately provide interested customers with the necessary information regarding these programs and related payment options, subscribe customers to their service option, and properly apply all relevant credits, payment plans, and benefits. Qwest will develop an "action plan" and "work collaboratively" with other parties.

Id. at 6-7.

31 The settlement provides that "Qwest and WeBTEC will attempt to enter into a Memorandum of Understanding (MOU) on specific rate stability provisions," and that "Qwest and DOD will attempt to enter into an agreement on specific rate stability provisions." *Id.* at 7. Finally, the settlement states "Dex Holdings, has represented to DOD that its present intent is to continue to publish the Government Listings directory section as it currently does." *Id.*

C. Support for the Settlement

32 Public Counsel, AARP, and WeBTEC argue that

> The Stipulation strikes a reasonable balance between the positions of Qwest, DOD, AARP, Public Counsel and WeBTEC. It was the result of months of hard negotiations and represents a true compromise by all parties to the Stipulation. It represents a compromise in the amount of the Washington share of the gain on sale to be distributed to ratepayers, a compromise on the way in which the ratepayers' share would be returned to them, and a compromise on certain other non-monetary benefits designed to address specific concerns about the implications and potential consequences of the sale raised by the various customer parties to the Stipulation.

Brief of AARP, Public Counsel and WeBTEC at 25-26. Mr. King, for DoD/FEA testified to similar effect:

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

Exhibit No. 286 (King Supplemental) at 5. The compromise nature of the settlement is further illustrated by Mr. Brosch in Exhibit No. 307C and by Mr. King in Exhibit No. 287C.

33 A consistent theme in the settling parties' supplemental testimonies in support of the settlement agreement is that the Commission's adoption of the agreement eliminates or at least mitigates legal risks, financial risks, and business risks that otherwise remain part of the public interest landscape. The elimination or reduction of risk via settlement approval, coupled with the level of customer benefits under the settlement led Mr. King to testify:

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

TR. 616.

D. Staff's Opposition

34 Commission Staff states its opposition to the settlement in the alternative. Staff's primary argument is that the Commission should reject the settlement agreement and Qwest's Application for Commission approval of the transaction. Staff's secondary argument is that the Commission should reject the settlement but approve the sale, subject to a set of

conditions Staff argues are required to ensure the transaction is consistent with the public interest.

35 Commission Staff's primary alternative is based on arguments that Qwest is getting less than fair market value for Dex, is understating the amount of gain that should be allocated to Washington customers, and is not providing 100 percent of the Washington gain to shareholders. *Staff Brief at 13-32.* Staff also argues that Qwest overstates the risks and potential consequences of a Qwest bankruptcy. *Id. at 32-44.* Finally, in this connection, Staff argues that a Washington stand-alone directory publishing right would leave QC with "a valuable and viable business enterprise." *Id. at 46.*

36 Staff's second alternative is to reject the settlement agreement, but to approve the Dex sale subject to certain conditions conceived by Staff "to capture all possible gains for ratepayers, and impose structural safeguards to protect the assets of QC from subsequent raids by [QCI]." *Id.* Staff grounds this part of its argument in notions of equity, stating, for example: "The Commission must never lose sight of the reason why Qwest is here in the first place – it is seeking sacrifices from QC ratepayers to bail [QCI] out of problems that are entirely of QCI's making." *Id.*

37 The conditions Staff advocates mirror, in part, conditions included in the settlement agreement, at least in principle. Staff argues that the Commission should require 10 percent of the Washington gain amount be returned to ratepayers in the form of an "upfront payment." This is the same position advocated by DoD/FEA in its direct case—a position from which it compromised to achieve agreement with Qwest and other parties.

38 Staff argues that imputation should be replaced by contract-based "compensation" from QCI to QC " for the expected amount that QC would otherwise realize from the directory publishing function" for the next 40 to 50 years. *Id. at 48.* Staff states that this would provide "QC customers with some protection from future rate increases." *Id.* The contract could be amended only with Commission approval. The underlying idea is the same as the revenue credits provided under the settlement agreement. The differences are in the mechanism to implement something equivalent, in effect, to imputation, and the duration.

39 In addition to the gain-sharing amounts and methods described above, Staff argues that the Commission should condition the sale by imposing "structural safeguards." *Id. at 50.* Staff's proposed conditions include QC debt/equity ratio restrictions, restrictions on QC's dividends, and restrictions on QCI's use of QC debt. Finally, Staff argues that the Commission should require "that any changes to the Publishing Agreement and any other ancillary or related agreement involving QC be made only with the Commission's approval." *Id. at 51.*

E. The Commission's Analysis and Decision.

1. Analysis.

40 The circumstances under which this matter is before us are grim. QC and Dex are saddled with the consequences of having been acquired by a company that through a combination of apparent mismanagement, alleged misdeeds, and unfortunate timing,[15] has been, to use the vernacular, "run into the ground." As Mr. Kennard testified, QCI would

[15] By "unfortunate timing" we mean the general downturn in U.S. financial markets over the past several years, the financial collapse of many deregulated sectors of the telecommunications industry during that period, and the devastating events of September 11, 2001, which broadly and deeply injured our nation's economy.

not be selling Dex—unquestionably a valuable asset the ownership of which continues to benefit QC and its customers—but for these circumstances. *TR. 338; see also Exhibit No. 64C (Reynolds) at 10.* As part of its corporate plan to de-lever its balance sheet and avoid bankruptcy, QCI has agreed to sell Dex. The sale has been consummated in seven of the fourteen states in which QC and Dex do business and is free to be consummated in five more. The status quo ante has been irretrievably lost.

41 We are presented stark choices. Any of the three outcomes advocated by the parties presents risks of harm to the public interest. In the context of this case, then, our challenge is to determine which outcome poses the least risk of harm.

42 RCW 80.01.040 defines our broadest responsibility as follows:

> The utilities and transportation commission shall: (1) Exercise all the powers and perform all the duties prescribed therefore by this Title . . . (3) Regulate in the public interest, as provided by the public service laws, the rates, services, facilities, and practices of all persons engaging within this state in the business of supplying any utility service or commodity to the public for compensation, and related activities; including, but not limited to . . . telecommunications companies.

Thus, we must concern ourselves not simply with risks and potential consequences for ratepayers, but also for Qwest and its shareholders, and for the general public.

43 Within the context of RCW 80.01.040, we are most specifically governed in this proceeding by the provisions of chapter 80.12 RCW and the regulations we have established under that statute in chapter 480-143 WAC. The statute and rules provide, in relevant parts:

> **RCW 80.12.020.** No public service company shall sell, lease, assign or otherwise dispose of the whole or any part of its franchises, properties or facilities whatsoever, which are necessary or useful in the performance of its duties to the public, and no public service company shall, by any means whatsoever, directly or indirectly, merge or consolidate any of its franchises, properties or facilities with any other public service company, without having secured from the commission an order authorizing it so to do.
>
> **WAC 480-143-120 Transfers of property.** A public service company may not complete a transfer of property necessary or useful to perform its public duties unless the company first applies for, and obtains, commission approval. Transfers include sale, lease, assignment of all or part of a public service company's property, and merger or consolidation of a public service company's property with another public service company. . .
>
> **WAC 480-143-170 Application in the public interest.** 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.

Thus, to rule on Qwest's Application, the Commission must determine whether the transaction is consistent with the public interest. There is no bright line against which to measure whether a particular transaction meets the public interest standard. As we observed in another case, "the approach for determining what is in the public interest varies with the form of the transaction and the attending circumstances." *In Re PacifiCorp* *and Scottish Power PLC, Docket No. UE-981627, Third Supplemental Order on Prehearing Conference (April 2, 1999), at 3.*

44 Stripped of rhetoric and hyperbole, much of the dispute in these proceedings is reduced to questions about what will happen in the future. If there is any one profound lesson exemplified by the facts that led us to where we are today, it is that the future is uncertain. No witness before us can reliably predict the future, nor can we. At best we can weigh the risks and consequences of the most probable future events against whatever certain results can be obtained today. These risks are both financial and legal, as we now discuss.

a. Bankruptcy Risk.

45 Considering our record as a whole, we find that the risk of a Qwest bankruptcy was significant in the months preceding QCI's announcement that it would sell Dex. QCI's announcement, and the subsequent sales agreement reached with Dex Holdings, decreased that risk, at least for the short and intermediate term. If the sale is not consummated, or even if it is only partially consummated, the risk of bankruptcy increases to some degree. We have no solid, quantitative measurement of how likely bankruptcy is under any scenario. Even with the sale, some risk of bankruptcy remains, though we do have testimony that is optimistic in this regard. *TR. 355 (Kennard) (" I think it becomes very remote that Qwest goes into bankruptcy if this deal is approved, because I think that they're basically out of the woods").*

46 The potential consequences of bankruptcy are serious. One possible outcome is that Dex would be sold under the supervision of the Bankruptcy Court, with the Commission's role, if any, unclear. *Exhibit No. 211 at 8 (Mabey).* Mr. Mabey regards this as a "highly likely" result. *Id. at*

17. This could mean that Qwest's creditors would take all the proceeds derived from the sale of Dex, with nothing going to Washington ratepayers. *Id.* In addition, "[t]he Bankruptcy Court could enjoin efforts by a state utilities commission to impute the sale's value to, for instance, QC if such imputation undermined the plan of reorganization or the statutory distribution scheme under the Bankruptcy Code." *Id.* Indeed, the Commission's ability to protect the public interest at all in the event of a Qwest bankruptcy proceeding is uncertain. *Id. at 10-12.* In sum, a bankruptcy filing by QCI, whether or not it initially included QC and/or Dex, raises the possibility that Dex would be sold under circumstances whereby the Commission would have little or no authority to protect ratepayer interests or the broader public interest.

47 If we approve the sale, conditioned as provided by the settlement agreement, we ensure that ratepayers obtain immediate benefit in the form of a substantial bill credit, and gain a measure of protection, through the revenue credit mechanism, with respect to ratepayers' longer-term interest in stable rates. We also improve the prospects of Qwest avoiding bankruptcy, thus promoting the shareholders' interests by giving the company time to recover financially and return increased value to its owners. These outcomes, while not guaranteed, appear to be positive for the Washington economy, the regional economy, and even the national economy.

48 Although we have no quantitative measures, we can qualitatively evaluate, as we do here, relative risk and potential consequences. The decision that results in the lowest risk of bankruptcy and least potential for harm to the public interest is to approve the sale subject to the conditions included in the settlement agreement.

b. Carve out.

49 Another possible outcome if we disapprove the sale is that it will go forward in the other 13 states where Qwest does business. Indeed, the sale has already been completed in seven states. In five of the remaining seven states approval has been granted or is not required. If our disapproval of the sale resulted in Washington being "carved out" to fare on its own, we would face a different, but no less worrisome set of uncertainties. Qwest would be left with an intangible asset—directory publishing rights in Washington—that might continue to be an asset of considerable value. The uncertainty we face concerns the questions of how to determine that value, how that value could be realized, and to what extent it would provide more or less benefit than the sale, as conditioned by the settlement terms or otherwise. The possibilities range from Staff's view that the transition to stand-alone directory publishing could be easily accomplished and would be highly lucrative, to Qwest's view that the transition would be difficult and is unlikely to provide QC with revenue "anywhere close" to the $103.4 –110 million in revenue credits provided under the settlement agreement. *Compare Staff Brief at 45-46 to Qwest Brief at 62-64; see also TR. 350-52 (Kennard); TR. 421-23, 444-48 (Burnett); TR. 976 (Selwyn).* Qwest actually suggested that directory publishing might actually need to be supported by ratepayers. *Qwest Brief at 64.* Dr. Selwyn conceded that revenue from stand-alone directory publishing for QC in Washington "might well be less than" today's imputation amount. *TR. 948.*

50 Again, we are in the realm of the uncertain future. Significantly, however, no witness testified that a stand-alone QC-Washington directory would be likely to provide revenue benefits to QC at the level of today's imputation amount. Under the settlement agreement that level of operating revenue, for purposes of rates, is continued for many years. Indeed, if Qwest files a

rate case during the early years, the revenue credit amount exceeds the company's estimate of the current imputation amount.

51 Considering all alternatives, approval of the settlement agreement best protects consumers' interests in stable rates. Definite benefits greater than, and then equal to, the current imputation amounts associated with directory publishing operations are required under the settlement terms during that period.

c. Litigation Risk.

52 The last category of risk we discuss in this section is litigation risk. The settling parties explicitly recognized this risk in agreeing to the compromise that is reflected in their settlement agreement. The parties face litigation risks in advocating their various positions before the Commission. The parties and the Commission face litigation risks if the Commission's final order is appealed.

53 The continuing nature of this risk is evidenced by the fact that Qwest devotes a significant part of its Initial Brief to challenging the Commission's legal authority. *Qwest Brief at 3-21.* Citing constitutional and statutory bases, Qwest challenges our jurisdiction over the transaction, our general authority to impose conditions on approval of the transaction, and our specific authority to impose the individual conditions proposed by Staff. Dex Holdings argues, "The likelihood of an appeal if the Commission departs from the settlement terms is relatively high." *Dex Holdings Brief at 20.* Although we do not doubt our jurisdiction we note that Qwest's arguments pass largely unanswered by Staff.

54 If we approve the sale, subject to the settlement conditions, we eliminate the risks of litigation. Those risks are not insubstantial. The potential consequences are significant. Protracted litigation could cause the transaction to fail, increasing the risk of a Qwest bankruptcy with the potential consequences we discuss above. Were a court to accept any or all of Qwest's legal arguments, the ratepayer benefits and public interest protections that we can promote by accepting the settlement agreement could be partially, or wholly, lost.

55 We are mindful in this context that all of the consumer interests actively represented in the case—that is, the parties whose clients[16] have a direct or indirect financial interest in the outcome of this proceeding—support the settlement agreement as a good compromise result considering the risks of litigation.

2. Decision.

56 Under WAC 480-143-170, we must reject a sale if we find it is "not consistent with the public interest." As supported by the foregoing discussion, we do not make that finding. Accordingly, the principal ground upon which we would be required to deny Qwest's Application has not been established. Compared to the alternatives, the settlement agreement offers as much certainty and relief from risk of harm to the public interest as can be achieved in the uncertain world of today's telecommunications business and the difficult financial circumstances that Qwest undoubtedly will continue to struggle to overcome.

[16] Public Counsel's "clients" include residential and small business and commercial ratepayers. AARP represents the interests of its members who are citizens in their late middle to elder years, many of whom are on fixed incomes. WeBTEC represents the interests of large customers. DoD/FEA is charged to protect the interests of the federal government as a major consumer of telecommunications services. Staff does take ratepayers' interests into account as part of its role in assisting the Commission to regulate in the public interest, but it is not a "consumer advocate" in the fashion of these other parties.

FINDINGS OF FACT

57 Having discussed above all matters material to our decision, and having stated general findings, the Commission now makes the following summary findings of fact. Those portions of the preceding discussion that include findings pertaining to the Commission's ultimate decisions are incorporated by this reference.

58 (1) The Washington Utilities and Transportation Commission is an agency of the State of Washington, vested by statute with authority to regulate rates, rules, regulations, practices, and accounts of public service companies, including electric companies.

59 (2) Qwest Corporation is a "public service company" and a "telecommunications company" as those terms are defined in RCW 80.04.010, and as those terms otherwise may be used in Title 80 RCW. Qwest Corporation is engaged in Washington State in the business of supplying utility services and commodities to the public for compensation.

60 (3) Qwest Corporation, on its own behalf and on behalf of its affiliates Qwest Dex, Inc., Qwest Services Corporation, and Qwest Communications International, Inc. (collectively "Qwest"), filed its "Application Regarding Transfer and Sale of Directory Business and Notice of Possible Affiliated Interest Transaction."

61 (4) On May 16, 2003, Qwest filed a Stipulation and Settlement Agreement joined in by Public Counsel, AARP, WeBTEC, DoD/FEA, and Dex Holdings, Inc. XO Washington does not oppose the settlement agreement. Commission Staff opposes the settlement agreement. The Stipulation and Settlement Agreement, attached to

this Order as Appendix B, is incorporated by reference into the body of this Order as if set forth in full. The Stipulation and Settlement Agreement would establish conditions, upon the Commission's approval, that confer certain benefits to ratepayers and others. The settlement conditions are in the public interest.

62 (5) Qwest's "Application Regarding Transfer and Sale of Directory Business and Notice of Possible Affiliated Interest Transaction" satisfies the company's obligations with respect to contracts or arrangements with affiliated interests.

63 (6) The proposed transaction, conditioned as provided in the Stipulation and Settlement Agreement, does not cause harm to the public interest.

64 (7) Commission approval and adoption of the Stipulation and Settlement Agreement reasonably resolves the contested issues in this proceeding and is in the public interest.

CONCLUSIONS OF LAW

65 (1) The Washington Utilities and Transportation Commission has jurisdiction over the subject matter of, and parties to, these proceedings. *Title 80 RCW.*

66 (2) The Stipulation and Settlement Agreement attached to this Order as Appendix B establishes conditions on the proposed sale of Qwest's directory publishing business that, upon the Commission's approval, confer certain benefits to ratepayers and others. The settlement conditions are in the public interest. *RCW 80.01.040.*

67 (3) The proposed transaction, conditioned as provided in the Stipulation and Settlement Agreement, is consistent with the public interest for purposes of the statutes and rules governing affiliated interest transactions. *Chapter 80.16 RCW; WAC 480-146-350.*

68 (4) The proposed transaction, conditioned as provided in the Stipulation and Settlement Agreement, is consistent with the public interest for purposes of the statutes and rules governing transfers of property. *Chapter 80.12 RCW; WAC 480-143-170.*

69 (5) Commission approval and adoption of the Stipulation and Settlement Agreement reasonably resolves the contested issues in this proceeding and is in the public interest. *RCW 80.01.040; WAC 480-09-466.*

70 (6) The Commission should retain jurisdiction to effectuate the terms of this Order. *Title 80 RCW.*

ORDER

THE COMMISSION ORDERS THAT:

71 (1) The Stipulation and Settlement Agreement filed by Qwest and other parties in this proceeding on May 16, 2003, and included in this Order as Appendix B, is approved and adopted as a reasonable resolution of the contested issues in this proceeding.

72 (2) Qwest's "Application Regarding Transfer and Sale of Directory Business" is granted, and Qwest's "Notice of Possible Affiliated Interest Transaction," is accepted, both as conditioned under the terms of the Stipulation and Settlement Agreement filed by Qwest and other parties in this proceeding on May 16, 2003.

73 (3) The Commission retains jurisdiction over the subject matter and the parties to effectuate the terms of this Order.

DATED at Olympia, Washington, and effective this 1st day of August 2003.

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

MARILYN SHOWALTER, Chairwoman

RICHARD HEMSTAD, Commissioner

PATRICK J. OSHIE, Commissioner

NOTICE TO PARTIES: This is a final order of the Commission with respect to certain issues resolved. In addition to judicial review, administrative relief may be available through a petition for reconsideration, filed within 10 days of the service of this order pursuant to RCW 34.05.470 and WAC 480-09-810, or a petition for rehearing pursuant to RCW 80.04.200 or RCW 81.04.200 and WAC 480-09-820(1).

APPENDIX A

OVERVIEW OF THE TRANSACTION PER QWEST CORPORATION'S APPLICATION

OVERVIEW OF THE TRANSACTION PER QWEST CORPORATION'S APPLICATION

- Assets. This transaction involves the sale of the entire business of Qwest Dex, Inc. ("Dex") in two stages which will close at different times, referred to respectively as "Dexter" and "Rodney." The first (Dexter) stage includes the Dex operations in Colorado, Iowa, Minnesota, Nebraska, New Mexico, North Dakota and South Dakota (the "Dexter Region"). The second (Rodney) stage includes the Dex operations in Arizona, Idaho, Montana, Oregon, Utah, Washington and Wyoming (the "Rodney Region").

- Purchase Price. $7.05 billion, subject to adjustment for working capital and final audited Dexter and Rodney financial statements. The purchase price is allocated $2.75 billion to Dexter and $4.3 billion to Rodney.

- Closing Dates. It is anticipated that Dexter will close in 2002 (the "first closing") and that Rodney will close six to twelve months after signing, depending upon how quickly state approvals (if required) are received (the "second closing"). The deadline for the first closing is December 15, 2002 and for the second closing is December 15, 2003.

- Closing Conditions. The consummation of the first closing and the second closing are conditioned, among other things, on (a) the receipt of debt financing on the terms set forth in Buyer's commitment letters, (b) the separation of the Dexter and Rodney businesses being consummated and (c) the termination or expiration of the applicable waiting period under the Hart-Scott-Rodino Act. The second closing may not occur in the event that state commissions, individually or collectively, order gain-sharing, rate reductions, additional capital investments or other forms of economic loss to QCI and/or its subsidiaries (including QC) in excess of a specified level.

- Mechanics of Closing. Just prior to the first closing, Qwest Dex, Inc. will transfer the Dexter assets and liabilities to its newly-created subsidiary, SGN LLC. At the first closing, the ownership of SGN LLC will transfer from Qwest Dex, Inc. to the Buyer. A similar course of events will occur just prior to and at the second closing for the Rodney sale through GPP LCC, a separate newly-created subsidiary of Qwest Dex, Inc.

- Other Operational Transaction Agreements. In addition to the purchase agreements governing the Dexter and Rodney transactions, agreements have been reached for the following commercial arrangements in connection with the transaction:

  ◊ Transition and Separation Arrangements.

    ♦ *Separation Agreement*. Rodney and Dexter will utilize shared assets, systems and facilities following the first closing in order to more efficiently and cost effectively operate the business prior to the second closing. This agreement establishes the key covenants and obligations necessary to share these resources and protect the parties' confidential information while maintaining operational integrity of the two companies. This agreement also sets forth the parties' respective responsibilities to separate the jointly maintained data, systems and processes and eliminate the dependence on transition services provided by the parties to each other if the Rodney closing fails, so that Dexter and Rodney will operate as completely independent companies.

- ♦ *Transition Services Agreement*. QCI and its subsidiaries will provide back-office and other support services to Dexter following the first closing for a period of up to 18 months.

- ♦ *Professional Services Agreement.* Dexter will provide necessary centralized services that Rodney will require following the first closing as a result of the transfer of certain personnel to Dexter at the first closing.

- ♦ *Joint Management Agreement*. Rodney and Dexter will each employ key senior management team executives during the transition period. The senior management team will run both companies consistent with applicable fiduciary duties and responsibilities. Conflicts of interest will be resolved by a liaison committee, if possible.

◊ *Publishing Agreement.* QC has entered into a publishing agreement designating the Buyer as QC's exclusive official publisher in the Region. In connection with the Publishing Agreement, QC and Buyer will enter into the following ancillary agreements:

- ♦ *Directory License Agreement.* QC will grant to the Buyer for the term of the Publishing Agreement a restricted license to use the directory publisher lists and directory delivery lists for the sole purpose of publishing and delivering the directories in the 14-state region.

- ♦ *Non-Directory License Agreement.* QC will grant to the Buyer a restricted license to use the subscriber list information in its direct marketing activities for a term of five years.

- ♦ *Public Pay Stations Agreement.* The Buyer will place directories in all of QC's public pay stations in the Region available for directory placement (with certain limited exceptions) for the term of the Publishing Agreement.

◊ *IP Contribution Agreement*. The assignment or licensing of QCI's and Qwest Dex, Inc.'s intellectual property used in the directory business to the Buyer is effected by the IP Contribution Agreement.

◊ *Trademark License Agreement*. The agreement grants Buyer a license to use the "Qwest Dex" trademark for a period of five years to sell directory products and direct marketing products primarily targeted at end users within the Region.

APPENDIX B

STIPULATION AND SETTLEMENT AGREEMENT