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IN THE MATTER OF QWEST COMMUNICATIONS INTERNATIONAL INC.'S, QWEST SERVICES CORPORATION'S, AND QWEST CORPORATION'S NOTICE OF SALE, REQUEST FOR WAIVER, OR APPLICATION FOR APPROVAL OF THE SALE OF THE ARIZONA OPERATIONS OF DEX, INC.

DOCKET NO. T-01051B-02-0666

NOTICE OF FILING SUPPLEMENTAL TESTIMONY

Staff of the Arizona Corporation Commission hereby provides Notice of Filing its Supplemental Testimony of Michael Brosch, in the above-referenced matter.

RESPECTFULLY SUBMITTED this 28th day of April, 2003.

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ARIZONA CORPORATION COMMISSION
UTILITIES DIVISION

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SUPPLEMENTAL

TESTIMONY

OF

MICHAEL BROSCH

IN THE MATTER OF QWEST COMMUNICATIONS, INTERNATIONAL, INC.'S, QWEST SERVICES CORPORATION'S, AND QWEST CORPORATION'S NOTICE OF SALE, REQUEST FOR WAIVER, OR APPLICATION FOR APPROVAL OF THE SALE OF THE ARIZONA OPERATIONS OF QWEST DEX, INC.

DOCKET NO. T-01051B-02-0666

APRIL 28, 2003

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF QWEST COMMUNICATIONS, INTERNATIONAL, INC.'S, QWEST SERVICES CORPORATION'S, AND QWEST CORPORATION'S NOTICE OF SALE, REQUEST FOR WAIVER, OR APPLICATION FOR APPROVAL OF THE SALE OF THE ARIZONA OPERATIONS OF QWEST DEX, INC.	:	Docket No. T-01051B-02-0666

SUPPLEMENTAL TESTIMONY

OF

MICHAEL BROSCH

ON BEHALF OF THE UTILITIES DIVISION STAFF

APRIL 28, 2003

Executive Summary of Testimony

Utilitech assisted Staff in negotiating a Stipulation of issues surrounding the pending sale of Dex. The Stipulation resolves the central dispute in this matter – whether or not an earlier 1988 Settlement Agreement remains in force, limiting the annual directory imputation credits to customers to $43 million. Qwest asserted that the 1988 Settlement Agreement represents the Commission's consent to transfer of all directory assets out of the telephone business as of 1984, resulting in no continuing Commission jurisdiction over the further transfer of Dex assets at this time and no current or future regulatory claim on the proceeds from the sale of Dex. Qwest argued that the 1988 Settlement Agreement remains effective to govern rate treatment of the directory publishing business in future Arizona rate cases.

As explained in my direct testimony, the sale of Dex should terminate the 1988 Settlement Agreement. The sale of Dex will eliminate the affiliate publishing arrangement with USWD (now Dex) that was the basis of the 1988 Settlement Agreement. My testimony explained that the 1988 Settlement Agreement pertained to and resolved a disputed specific transfer of certain assets among corporate affiliates that occurred in 1984 and did not contemplate or address the pending sale of the publishing business enterprise to a non-affiliated buyer.

The Stipulation adopts Staff's view that the 1988 Settlement Agreement must be replaced with a new agreement with increased annual revenue credits to Qwest Corporation's ratemaking income statement. The sale of Dex yields a very large gain on sale that should be used to benefit customers. The Stipulation is a compromise that uses most of the Arizona portion of this gain to maintain and increase the imputation adjustment amount embedded within customers' rates from $43 million annually to $72 million per year for 15 years. This prospective adjustment will cause future QC revenue requirements to be lower than under the 1988 Settlement Agreement. These ratemaking imputation adjustments recognize that historically Dex has been treated as a source of jurisdictional telephone company revenue in Arizona and that ratepayers have a vested interest in the fees and value associated with the directory business.

The 1988 Settlement Agreement that is being replaced by the new Stipulation has been controversial to administer in the past, due to ambiguities surrounding the definition and measurement of "value of fees and services". The new Stipulation provides for annual revenue imputation adjustments that are fixed in amount for future rate cases and not subject to adjustment based upon future showings of "value" or other subjective changes.

The Stipulation should be approved because it provides certainty and finality to a controversial element of Qwest regulation, while addressing the Company's need for financial liquidity and customers' need for increased revenue imputations from the directory publishing business in ratemaking proceedings.

Q. Please state your name and business address.

A. My name is Michael L. Brosch. My business address is 740 Northwest Blue Parkway, Suite 204, Lee's Summit, Missouri 64086.

Q. Are you the same Michael L. Brosch who previously submitted testimony in this Docket?

A. Yes. My qualifications are described in that previous testimony.

Q. What is the purpose of your testimony at this time?

A. My testimony is supportive of the Stipulation that was negotiated between Staff and the Qwest parties. I explain why the Stipulation is reasonable, consistent with the public interest, and should be approved by the Commission.

Q. What are the substantive provisions of the Stipulation?

A. The Stipulation allows Qwest to sell the Dex business and apply the cash proceeds to debt repayment and provides for increased customer benefits from the Dex sale in the following manner:

- Commission approval of the sale of Dex and the Arizona directory assets of Dex, pursuant to the Rodney transaction documentation, is conditioned upon firm, fixed amounts of imputed revenues to the telephone company in future rate proceedings.
- Replacement of the 1988 Settlement Agreement that had served to limit annual directory imputation to only $43 million per year, subject to adjustment based upon the "value of fees and services".
- Increasing the annual directory revenue imputation to $72 million per year for all ratemaking proceedings within a fixed 15-year term, and with no potential adjustment or reduction in such amounts.
- Explicit inclusion of the increased $72 million imputation of revenues within the Qwest Price Cap Review filing that is anticipated later this year, so the Commission can consider any rate changes that may be appropriate in connection with continuation or modification of the Price Cap Plan.

- Recognition of the $72 million of directory revenue imputation in all reporting of Qwest Corporation's Arizona earnings and intrastate rate of return for the next 15 years.

These provisions resulted from extensive negotiations between Staff and Qwest and represent a compromise of the positions taken by each party in pre-filed evidence in this Docket.

Q. Why is the existing 1988 Settlement Agreement important in the Commission's review of the Dex sale transaction at this time?

A. The Arizona directory publishing assets of Mountain Bell were transferred to an affiliated company at divestiture in 1984. This transfer was disputed and ultimately rejected by the ACC, resulting in litigation that was resolved by the 1988 Settlement Agreement. Qwest argued that, through the 1988 Settlement Agreement, the Commission has already approved the transfer of the directory business to an unregulated affiliate, causing the directory assets to not be public service corporation assets and the pending sale of Dex to not fall within the scope of Arizona's asset transfer statute.[1] Alternatively, if the Commission has any jurisdiction over the pending sale, Qwest asserted that the 1988 Settlement Agreement, "ensures that the benefit of directory imputation included in current rates will remain in place, and will insulate ratepayers from any adverse rate affects based on the sale of Dex".[2] My Direct Testimony rebutted these assertions and explained Staff's view that the 1988 Settlement Agreement is terminated by the proposed sale of Dex to a non-affiliate.

Q. Has the 1988 Settlement Agreement been the subject of controversy in spite of its specification of $43 million in annual revenue imputation to the telephone company?

A. Yes. The 1988 Settlement Agreement had the effect of freezing the directory revenue imputation adjustment in rate cases, based upon directory profit levels being earned in the

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1 Testimony of Maureen Arnold, page 4.
2 Id. Page 5.

mid-1980's. However, actual directory publishing profits have continued to grow and all of this growth has been retained for the sole benefit shareholders in Arizona, to the detriment of ratepayers. In other Qwest jurisdictions that do not have such a one-sided settlement, directory profitability and imputation adjustments have grown substantially since the mid 1980's. For example, the U S West 1997 Washington rate case produced an imputation value of $85 million in a state similar in size to Arizona. Utah's 1997 U S West rate case yielded an imputation order of $30 million per year, even though Utah is less than half the size of Arizona. In the 1993 Arizona rate case of U S West, this Commission accepted my calculation of a $60 million imputation adjustment, only to have this finding reversed upon appeal because of the 1988 Settlement Agreement.[3]

In the most recent 1999 Arizona rate case, Qwest advocated a zero directory revenue imputation amount through its interpretation of the 1988 Settlement Agreement and its evaluation of the "value of fees and services", as required under that Settlement. I calculated the much larger imputation credit that would be equitable to customers in 1999, but included only $43 million in Staff's filing in deference to the 1988 Settlement Agreement and the Court's interpretation of that Settlement. This $43 million value was used to determine the start-up revenue requirement within the current Price Cap Plan.

Q. **If the Commission agreed with Qwest's view that the 1988 Settlement Agreement continued to apply after Dex is sold, would the Company still be able to argue in future rate cases that the "value of fees and services" being received by the telephone company under the new Publishing Agreement with Dex Holdings L.L.C. justifies downward adjustment or elimination of the $43 million in imputation credits provided for in that Settlement Agreement?**

A. Yes. It is reasonable to anticipate that Qwest would again assert its argument that satisfaction by Dex of the telephone company's publishing obligation to produce and

3 Brosch Direct Testimony, page 25.

distribute white pages directories, at no cost to the telephone company, represents substantial "value" to the telephone company in lieu of imputation. The facts supporting these arguments, as raised by the Company in the 1999 rate case, will remain in place under the new Publishing Agreement with Dex Holdings L.L.C. In addition, Qwest continues to argue that imputation of directory revenues is an improper subsidy and is otherwise objectionable as a matter of public policy. Staff rejects these arguments and would vigorously defend its view that imputation remains appropriate in spite of Qwest's continuing opposition, but these controversies are all resolved under the Stipulation.

Q. How does the new Stipulation address the problems that have surrounded the 1988 Settlement Agreement?

A. The Stipulation supercedes and replaces the 1988 Settlement Agreement. The Stipulation increases the $43 million in annual revenue imputation by 67 percent, to $72 million per year. Perhaps more importantly, the new and larger revenue imputation is fixed in amount and not subject to adjustment based upon a vaguely defined "value of fees and services" provision. Qwest has no opportunity to argue that directory imputation should be reduced prior to the expiration of the 15-year term specified for the new revenue imputation adjustment. Thus, considerable litigation risk associated with this Docket and many future rate proceedings is eliminated. Customers of Qwest's intrastate Arizona telephone services are assured long-term participation in the profits earned through directory publishing, even though the business enterprise creating such profits is being sold.

Q. How does the negotiated $72 million in annual credits compare to your recommendation in Direct Testimony?

A. Assuming continued price cap regulation in Arizona, my pre-filed Direct Testimony in this Docket recommended perpetual directory imputation adjustments of $100 million per year. This recommendation was based upon retention for ratepayers of 100 percent of my calculation of the Arizona share of the gain to be realized on sale of the Dex directory publishing business. As an alternative recommendation, if the Commission decided to terminate the Price Cap Plan and revert to traditional rate case regulation, my testimony supported crediting of the Arizona share of the entire gain to customers based upon a 20-year amortization that produced a $121.3 million annual customer credit. My calculations of these amounts are set forth in Confidential Exhibit ___ MLB-1 and include a series of gain allocation steps and present value discount rates that are disputed by Qwest. The Stipulation represents a compromise that provides $72 million in annual imputation credits for 15 years, irrespective of the form of regulation that is used.

Q. Are customers assured of near-term benefits from the increase in imputation provided for in the Stipulation?

A. Yes. The initial term of the Arizona Price Cap Plan is due to expire in 2004 and Qwest anticipates filing its proposals regarding continuation or modification of the Plan, as well as a required earnings calculation, on or about July 1, 2003. Paragraph 3 of the Stipulation requires the increased imputation amount be included in Qwest's calculation of intrastate earnings and rate of return for these purposes. Staff will review these calculations in formulating its recommendations regarding any rate changes or other relief that should be a part of future Qwest regulation. The stipulated increase in directory imputation will make the Company's intrastate revenue requirement $29 million lower than would otherwise be calculated later this year.

Q. What are the benefits to Qwest under the Stipulation?

A. Qwest is able to secure ACC approval for the sale of Dex, removing a contingency and possibly expediting sale closure, particularly if a settlement is also achieved in Washington, which is the last state where regulatory approval is required. The large cash infusion from the Dex sale proceeds will enable the Company to repay debt obligations and improve the financial condition of the business, removing some of the risks that jeopardize Qwest's access to capital markets on reasonable terms. Additionally, the Stipulation resolves with certainty the contentious issue of directory imputation, which should simplify and reduce Qwest's costs associated with future regulation in Arizona.

Q. Can the specific terms and amounts in the Stipulation be compared with settlements reached in other states having jurisdiction over the sale of Dex?

A. No. The circumstances in Arizona are unique because of the 1988 Settlement Agreement and the history of litigation surrounding that agreement, as well as the existing Arizona Price Cap Plan and scheduled review of that plan later this year. Other Qwest states have unique regulatory histories with regard to directory publication and differences in the regulatory framework that must be considered.

Q. In your opinion, for the reasons stated above, is the Stipulation reasonable and consistent with the public interest?

A. Yes.

Q. Does this conclude your testimony at this time?

A. Yes, it does.