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BEFORE THE ARIZONA CORPORATION COMMISSION

MARC SPITZER
Chairman
JAMES M. IRVIN
Commissioner
WILLIAM MUNDELL
Commissioner
JEFF HATCH-MILLER
Commissioner
MIKE GLEASON
Commissioner

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

QWEST CORPORATION'S POST HEARING BRIEF

INTRODUCTION

I. THE SALE TRANSACTION.

On August 19, 2002, Qwest Communications International ("QCI") agreed to sell the directory publishing business of its subsidiary, Qwest Dex, Inc. ("Dex"), to Dex Holdings, LLC, an entity formed by the private equity firms of The Carlyle Group and Welsh, Carson, Anderson & Stowe ("Buyer"). *See* Direct Testimony of Maureen Arnold, Exhibit Q-4 ("Arnold Direct") at 3. The total purchase price for the transaction – the result of a bid and auction process designed to obtain the fair market value for the Dex business – is $7.05 billion. *See* Direct Testimony of Brian G. Johnson, Exhibit Q-2 ("BG Johnson Direct") at 6. Qwest Corporation ("Qwest") was not a party to the purchase agreements, though it did enter into a separate publishing agreement with Buyer and joined QCI in a non-competition agreement with Buyer.

The sale of Dex was separated into two stages; the first stage, termed "Dexter," closed on

November 8, 2002, and included all Dex operations in Colorado, Iowa, Minnesota, Nebraska, New Mexico, North Dakota and South Dakota. The Dexter purchase price was $2.75 billion. The second stage of the sale, termed "Rodney," includes all Dex operations in Arizona, Idaho, Montana, Oregon, Utah, Washington and Wyoming for an agreed purchase price of $4.30 billion. Arnold Direct at 6. The Rodney sale is scheduled to close in 2003. *Id.*

II. FINANCIAL NECESSITY OF THE SALE.

QCI's decision to sell Dex came at a critical juncture in its overall strategy to preserve and strengthen its financial integrity. QCI's and Qwest's steadily worsening financial situations and debt loads began to significantly impact their ability to obtain financing at the beginning of 2002. *See* Direct Testimony of Peter C. Cummings, Exhibit Q-1 ("Cummings Direct") at 10. In January 2002 QCI had declining EBITDA, declining revenues, and over $25 billion of debt on the books. Cummings Direct at 9. QCI's stock price was in steep decline from the mid-$40s in January 2001 to the mid-teens by January 2002, and eventually declined as low as $1.07 on August 7, 2002. *Id.; see also,* Exhibit PCC-2 to Cummings Direct. Both QCI and QC found themselves locked out of short-term commercial paper market (*Id.* at 11), and saw their debt ratings decline into junk status. *Id.* These significant financial downturns left QCI in very real danger of being unable to generate sufficient cash flow to service its debt obligations. QCI had fully drawn down its existing $4.0 billion credit facility as a consequence of being shut out of the commercial paper market, and faced potential default under that facility if it could not reduce debt and find a source of cash to meet those obligations, originally scheduled to mature on May 3, 2002, and subsequently extended to May 3, 2003. *Id.* at 14.

The sale of Dex became a critical component of QCI's overall debt restructuring and de-levering strategy. Unrefuted testimony in this docket has established that the Dex sale was essential to successfully negotiating QCI's Second Amended and Restated Credit Agreement ("ARCA"). BG Johnson Direct at 8. The ARCA extended maturities coming due in 2003 under QCI's prior credit agreement, and also relaxed the debt-to-EBITDA covenant ratios under the prior Credit Agreement. *Id.* Given QCI's debt load at the time, and its lack of sufficient cash flow to meet the $4 billion repayment obligation in May 2003 under the existing credit agreement, QCI would likely have defaulted under that credit agreement had it not been able to negotiate the ARCA. *Id.* While the ARCA, the completion of the first phase of the Dex sale, and other successful debt restructuring initiatives have improved QCI's and Qwest's financial situation, the proceeds from the second phase of the Dex sale remain critically important if QCI is to execute on its plan to reduce debt, de-lever the balance sheet, and return both QCI and Qwest to financial health. BG Johnson Direct at 10-11. The short-term financial necessity of the Dex sale is not challenged by any party, and Staff and The United States Department of Defense/Federal Executive Agencies ("DOD") affirmatively acknowledge that, for this reason, the sale is in the public interest, provided that any ratepayer interest in the directory operations is adequately satisfied as a condition of the sale. *See* Discussion, Section III, *infra.* at 17-18.

III. THE STIPULATION.

On August 30, 2002, QCI, QSC, and QC filed notice with the Commission of the Dex sale. The notice requested that the Commission declare that: (1) the transaction fell within the scope of the waiver granted in Commission Decision No. 58087; or (2) the Dex sale was not subject to Commission regulation. Alternatively, the notice requested that the Commission either waive compliance with its Affiliated Interest Rules, A.A.C. R-14-2-801 through –806 (the "Rules"), or approve the sale.

Intervention was granted to the Residential Utility Consumer Office ("RUCO"), the DOD, Buyer and WorldCom, Inc. ("WorldCom").[1] Pursuant to various procedural orders, the parties filed testimony concerning the notice and a hearing was ultimately scheduled for May 2003.

In the interim, Qwest and Staff entered into settlement negotiations and, after months of negotiations, reached an agreement, which they reduced to a stipulation and filed on March 28, 2003 (the "Stipulation"). RUCO and DOD were offered the opportunity to join in the Stipulation,

[1] WorldCom was granted limited intervention and monitored, but did not file testimony in the docket.

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but declined. Qwest addresses later in its brief the concerns raised by RUCO and DOD concerning the Stipulation. The parties filed testimony concerning the Stipulation and a hearing was conducted on the settlement on May 27 and 28, 2003.

The Stipulation supersedes a prior 1988 Settlement Agreement relating to directory imputation and conveys significant benefits to Arizona ratepayers in the form of increased imputation of $72 million per year for the next 15 years. Testimony of Maureen Arnold in Support of Stipulation, Ex. Q-6 ("Arnold Settlement Testimony") at 2-3; Transcript of Proceeding at 141-42, *In the Matter of Qwest Communications International, Inc., Qwest Services Corporation's and Qwest Corporation's Notice of Sale, Request for Waiver, or Application for Approval fo the Sale of the Arizona Operations of Qwest Dex, Inc.* ("Dex Proceeding"). This constitutes an increase of 67% or $29 million above the current, baseline imputation ($43 million per year) under the 1988 Settlement Agreement. *Id.* This increased imputation will be immediately reflected and captured in Qwest's Price Cap Plan filing on July 1, 2003. *Id.* Pursuant to the Stipulation the $72 million annual imputation remains in effect until the year 2018, and cannot be challenged during that time. At the end of this 15-year period, the imputation benefits cease according to the terms of the Stipulation.

Qwest and Staff agree that the Stipulation is a fair and reasonable compromise of disputed positions that adequately satisfies any ratepayer interest in directory publishing. Arnold Settlement Testimony at 2; Brosch Supplemental Executive Summary. Qwest and Staff agree that the Stipulation effectively serves the public interest. *Id.* The Stipulation helps ensure the long-term viability of Qwest while providing for increased imputation that benefits Arizona ratepayers. Arnold Settlement Testimony at 2-3; Transcript of Proceeding at 141-42, Dex Proceeding. Accordingly, Qwest urges the Commission to approve the Stipulation as filed. In order to understand why the Stipulation is in the public interest, it is necessary to evaluate the history of directory publishing and directory revenue imputation in Arizona, and the litigation risk faced by Staff in agreeing to the Stipulation.

DISCUSSION

I. THE HISTORY OF DIRECTORY PUBLISHING OPERATIONS IN ARIZONA.

A. Divestiture.

Prior to 1983, The Mountain States Telephone and Telegraph ("Mountain Bell") was a Bell Operating Company ("BOC") providing telecommunications services in Arizona as a subsidiary of American Telephone & Telegraph Company ("AT&T"). At the divestiture of AT&T, the Plan of Reorganization allocated ownership of 22 BOC subsidiaries among seven newly created Regional Holding Companies. As a result of this process, Mountain Bell became a wholly owned subsidiary of U S WEST, Inc., the Regional Holding Company serving Arizona and other western states. Arnold Direct at 6. In the Modified Final Judgment that accomplished the divestiture of AT&T, Judge Harold Greene assigned directory publishing assets to each BOC that had been publishing White and Yellow page directories prior to divestiture.[2]

In 1984, Mountain Bell transferred its directory publishing assets and business to its affiliate, U S WEST Direct ("USWD"), another subsidiary of U S WEST, Inc. The Commission challenged the transfer by issuing an Order to Show Cause why Commission approval was not necessary in light of A.R.S. § 40-285.[3] In that proceeding, the Commission declared the transfer

[2] DOD witness Richard Lee maintains that Judge Greene ordered that directories remain with the local exchange companies in order to ensure that directory revenues would continue to subsidize rates for local exchange services. Rebuttal Testimony of Richard Lee at 5. Although mindful of the subsidy provided to local telephone rates by the BOC's directory publishing business, Judge Greene's primary concern was to eliminate the concentration of market power that would occur if directory publishing remained with AT&T. *United States v. Am. Tel. & Tel. Co.,* 552 F. Supp. 131, 193 (D.D.C. 1982), *aff'd* 460 U.S. 1001, 103 S.Ct. 1240. In any case, nothing in the Modified Final Judgment suggests that Judge Greene sought to create a perpetual subsidy right, as asserted by Mr. Lee, and, importantly, the Modified Final Judgment was vacated with the enactment of the Telecommunications Act of 1996, and is no longer the law. *See* Grate Surrebuttal at 14.

[3] A.R.S. § 40-285(A) provides "A public service corporation shall not sell, lease, assign, mortgage or otherwise dispose of or encumber the whole or any part of its railroad, line, plant, or system necessary or useful in the performance of its duties to the public, or any franchise or permit or any right thereunder, nor shall such corporation merge such system or any part thereof with any other public service corporation without first having secured from the commission an order authorizing to do so. Every such disposition, encumbrance or merger made other than in accordance with the order of the commission authorizing it is void."

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of directory publishing assets from Mountain Bell to USWD void, and Mountain Bell appealed that order in Superior Court. *See* Case No. CV 87-33850; Decision No. 55755 (October 8, 1987).

B. The 1988 Settlement Agreement.

In order to resolve Mountain Bell's challenge of Decision No. 55755, Staff entered into a settlement agreement (the "1988 Settlement Agreement") (Exhibit Q-9) with Mountain Bell, which was later approved in Decision No. 56020 (June 13, 1988). The 1988 Settlement Agreement provided: (1) the transfer of directory publishing assets from Mountain Bell to USWD was valid; and (2) the Commission would "take no further action to challenge that transfer." *See* Section 3(b), 1988 Settlement Agreement. Accordingly, upon Commission approval of the 1988 Settlement Agreement, and at all times thereafter, the directory publishing assets have been held, not by the regulated public service corporation (Mountain Bell or its successor), but by an unregulated affiliate (USWD or its successor).

In return, the 1988 Settlement Agreement provided that "in future rate cases filed by Mountain Bell, the Commission, in arriving at the test year operating income of Mountain Bell, will consider the fees and the value of services received by Mountain Bell from USWD under publishing agreements with USWD." Section 3(c), 1988 Settlement Agreement. The agreement further noted that this amount had been established at $43 million in Mountain Bell's 1984 rate case,[4] and provided that subsequent adjustments downward from the $43 million amount were possible. The agreement, on its face, did not discuss potential increases to the $43 million dollar amount. *See* Section 3(c), 1988 Settlement Agreement.

C. 1993 Rate Case.

On July 15, 1993, Mountain Bell's successor, U S WEST Communications, Inc. ("USWC"), applied for an increase to its intrastate rates. Arnold Direct at 9. In its application,

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[4] Although the 1988 Settlement Agreement does not use the word "imputation," it does speak to increasing Mountain Bell's test year operating income by the "fees and the value of services received" from the directory publisher. For ease of reference, Qwest will refer to this an "imputation" amount, as has been the convention in subsequent rate cases.

USWC did not seek a decrease in the $43 million annual imputation for the value of fees and services from USWD, as established in the 1988 Settlement Agreement. However, Staff recommended a $17.6 million increase to the $43 million imputation based on the profitability of USWD's Yellow Pages. The Commission adopted Staff's recommendations on the increased imputation in Decision No. 58927 (January 3, 1995). This Decision was appealed by USWC directly to the Arizona Court of Appeals pursuant to A.R.S. § 40-254.01. *Id.*

In *U S WEST Communications, Inc. v. Arizona Corp. Com'n*, 185 Ariz. 277, 915 P.2d 1232 (App. 1996) ("*U S WEST'*), the Court held that the Commission's directory imputation of approximately $60 million violated the 1988 Settlement Agreement because the calculation was based on treating USWD as a regulated entity, and not on the value of fees and services derived by USWC from USWD:

> It is wholly inconsistent with this [1988 Settlement] agreement to impute to US West all of USWD's profits in exceeding the rate of return USWD would have been permitted to receive had it remained regulated and to seek thereby for 'ratepayers the same benefit from the directory publishing business as they had before the assets were transferred.' By such a methodology the Commission in effect pretends that the transfer it previously accepted did not occur. The imputation method approved in the agreement was not the excess-profit imputation adopted by the Commission but rather a method dependent upon proof of 'the fees and the value of service received by Mountain Bell from USWD under publishing agreements with USWD.'

Id. at 281, 915 P.2d at 1236.

While the Court held that the 1988 Settlement Agreement did allow for the upward or downward adjustment of the $43 million imputation, it held that Commission could adjust the imputation amount based only upon a showing that the value of fees and services USWC derived from USWD was higher or lower than the presumptive amount contained in the 1988 Settlement Agreement:

> The agreement authorizes the Commission staff to 'present evidence in support of or in contradiction to' whatever value US West and USWD might assign to fees and services, and it entitles the Commission to adjust the presumptive $43 million imputation

> either upward or downward as the evidence of fees and services supports.

Id. at 281, 915 P.2d at 1236. The Court expressly noted the Commission's agreement to "'take no further action to challenge' Mountain Bell's transfer of yellow pages assets to USWD." *Id.* at 280, 915 P.2d at 1235. The Court stated that under this provision of the 1988 Settlement Agreement, the Commission could not indirectly challenge the asset transfer by adopting an imputation methodology that "pretended that the transfer it previously accepted did not occur." *Id.* Since the parties had agreed that presumptive amount of imputation under the 1988 Settlement Agreement was $ 43 million, and no other evidence of the value of fees and services was presented to the Commission, the Court ordered that "[w]e set aside the Commission's greater imputation and direct it on remand to impute only $ 43 million of directory revenue." *Id.*

Thus, the 1988 Settlement Agreement, which continues to apply unless superseded by the Stipulation, does not provide the Commission with any basis to assert jurisdiction over the sale of Dex. In fact, it makes clear that the directory assets are no longer held by the public service corporation (Qwest), and that the Commission has accepted the validity of that transfer.

D. <u>1999 Price Cap Plan.</u>

On January 8, 1999, USWC (now Qwest Corporation) filed a rate application with the Commission. Qwest and Staff eventually entered into a proposed Price Cap Plan settlement agreement ("Price Cap Plan"). Both Staff and Qwest testified that the Price Cap Plan incorporated the same level of directory imputation contained in the orders on remand from the Arizona Court of Appeals decision relating to the 1993 rate case. As part of the Price Cap Plan, Qwest and Staff agreed that $43 million would be imputed into Qwest's revenue requirement as the value of fees and services that Qwest received from Dex. Staff Witness Michael Brosch, who is also Staff's witness in this proceeding, testified:

> Brosch: I proposed an adjustment of that approximate amount that was designed to comply with the earlier [1988] settlement agreement between Staff and the company that arguably was violated in the last case where I attempted a larger imputation.

See Transcript of Proceedings (December 1, 2001) at 508, *In the Matter of the Application of US West Communications, Inc., A Colorado Corporation, for a Hearing to Determine the Earnings of the Company, the Fair Value of the Company for Ratemaking Purposes, to Fix a Just and Reasonable Rate of Return Thereon and to Approve Rate Schedules Designed to Develop Such Return*, Docket No. T-01051B-99-0105, et al. ("Price Cap Application").

Qwest Witness George Redding testified:

> Redding: Also in the process of developing the revenue requirement, we considered all the adjustments that had been made by all of the parties in the various – that presented revenue requirements or adjustments. The primary premise was that we accepted adjustments that were consistent with the prior rate case. For example, directory is one of the most obvious ones of that.

Id. at 127.

Thus, the testimony of both Brosch and Redding make clear that the Price Cap Plan incorporated $43 million in directory revenues. Although the amount of the revenue requirement under the Price Cap Plan was altered, the amount of directory revenue imputation was not. The issue of directory imputation was discussed at length during the Commission's March 7, 2001 Open Meeting. Commissioner Spitzer proposed Amendment No. 3 – which would have adjusted the $43 million imputation based solely on the change in the Consumer Price Index from 1988 to 2000.[5] Both Staff witness Michael Brosch and Commission Chief Counsel Chris Kempley addressed Commission Spitzer's Amendment No. 3 and indicated that the proposed amendment was inconsistent with the 1988 Settlement Agreement, as interpreted by the Court of Appeals. They stated the need to address imputation within the parameters of the Court of Appeals' ruling in 1996 on the binding effect of the 1988 Settlement Agreement.

> Brosch: If you look at the numbers without regard to the [1988] settlement agreement, in the court's review, certainly all of the evidence points to a larger imputation being appropriate, and that was the excerpted testimony that I believe AT&T made reference to in its exceptions to the proposed order. However, within the constraints of the settlement agreement, and requirement to address

[5] Open Meeting Transcript (March 7, 2001) at 230, Price Cap Application.

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> the value of fees and services received by the telephone company from the publishing affiliate, within those constraints you can't get there, and that's the thrust of my testimony.
>
> Kempley: Mr. Chairman, Commissioner Spitzer, I'm in the unfortunate position of having to agree with Mr. Berg on this matter. And it's not at all, in my view, a problem that the Commission is unable to increase the imputation amount. It is the combination of events, which is that the Commission can either increase or decrease the imputation amount, but that by virtue of the settlement agreement the analysis that has to take place in order to support that, such a shift has to relate to the value of the fees and services. And from a strict evidentiary perspective, let me be candid, we thought long and hard about whether we could come up with a way to justify a number that would be, in Mr. Brosch's words, more appropriate, i.e., higher, and couldn't come up with a way to get there based on the limitations placed in the settlement agreement.
>
> Spitzer: In the 1988 settlement agreement?
>
> Kempley: In the 1988 settlement agreement.

Open Meeting Transcript (March 7, 2001) at 231-233, Price Cap Application.

When Mr. Kempley offered avenues other than directory imputation as a means for the Commission to address any concerns about Qwest's revenue requirement under the Price Cap Plan (*Id.* at 233-234), Teresa Wahlert, Qwest's Vice-President of Arizona Operations, responded:

> Wahlert: Based on what Chris has suggested, Qwest is willing to discuss other ways of perhaps arriving at a revenue requirement adjustment. Qwest, as Mr. Berg stated, is not willing to put on the table this particular issue [increased directory imputation] because of the court order, but I understand that I believe there is an issue yet to be unanswered on revenue requirements, and if we want to explore that, we came here today ready to explore that. If we can work on the issue of revenue requirement not associated with any particular adjustment as the rest of the settlement was done, we are willing to have that discussion.

Id. at 236-237.

Finally, in this proceeding, Staff witness Brosch acknowledged that Staff adhered to the $43 million imputation requirement of the 1988 Settlement Agreement in formulating the Price Cap Plan.

> Brosch: 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 service,' as required under that Settlement. I calculated a 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. The $43 million value was used to determine the start-up revenue requirement with the current Price Cap Plan.

Supplemental Testimony of Michael Brosch at 6.

The record is clear – although the Commission subsequently adjusted the revenue requirement downward in order to reduce rates for Basket 1 services in the Price Cap Plan, the $43 million imputation contained in the proposed settlement between Qwest and Staff remained unchanged. Decision No. 63487 and the Price Cap Plan recognize the precedent set in the 1988 Settlement Agreement.

II. THE COMMISSION LACKS JURISDICTION OVER QCI's SALE OF DEX.

A. The 1988 Settlement Agreement.

Based on the 1988 Settlement Agreement between Mountain Bell and the Commission, and the Arizona Court of Appeals decision relating to that settlement, the Commission now lacks the jurisdiction to either approve or deny the sale of QCI's directory publishing assets to a third party buyer. Paragraph 3(b) of the 1988 Settlement Agreement expressly states that "the parties agree that the transfer of Yellow Pages assets from Mountain Bell to USWD will be accepted by the parties as valid and the Commission will take no further action to challenge that transfer." Once the Commission approved the 1988 Settlement Agreement, all directory-publishing assets came into control by USWD, an *unregulated* affiliate of Mountain Bell.

In *U S WEST*, the Court of Appeals opined "[t]he Commission unequivocally agreed in 1988 to accept the transfer of directory publication to an unregulated affiliate." 185 Ariz. at 281, 915 P.2d at 1236. Once the Commission accepted the transfer as lawful, it lost the ability to approve or disapprove of any transfer of assets by Dex, whether to another affiliate or to a third party. The Arizona Court of Appeals was quite clear in stating that the Commission, in the future, could no longer challenge the transfer of USWD either directly or indirectly. *Id.* The Commission is not "free to pretend that the transfer that it had accepted did not occur." *Id.* A.R.S. § 40-285 does not apply to a transfer of assets from an unregulated affiliate of a public service corporation.

Of course, the Commission need not reach the question of whether it has jurisdiction to approve this transaction, whether under A.R.S. § 40-285 or other provision of Arizona law, if it adopts and approves the Stipulation. The point of this discussion is to underscore that, if the Commission does not adopt the Stipulation and approve the sale, there is a compelling argument to be made that, based on the 1988 Settlement Agreement and the Arizona Court of Appeals decision, the Commission did not have jurisdiction to approve the transaction in the first place. That is a significant factor that Staff quite correctly considered, among other factors, in agreeing to the Stipulation. Transcript of Proceedings at 179, Dex Proceeding. It is a factor that the Commission must equally consider in weighing whether the Stipulation serves the public interest. Qwest discusses this litigation risk factor, and other litigation risk factors, in Section IV.A, *infra*.

B. The Commission's Rules Do Not Apply to the Dex Transaction.

The Commission's lack of approval jurisdiction under A.R.S. § 40-285 should be clear, based on the 1988 Settlement Agreement. Nor can the Commission assert jurisdiction to approve the sale under its Public Utility Holding Companies and Affiliates Interests Rules. The authority granted to the Commission by Article 15, § 3 of the Arizona Constitution is limited to its regulation of public service corporations. *See, e.g., Rural/Metro Corp. v. Ariz. Corp. Comm'n*, 129 Ariz. 116, 117-18, 629 P.2d 83, 84-85 (1981) (holding that the legislature could not delegate authority to the Commission to regulate businesses not defined as "public service corporation" in Article 15, § 2). Here, there is no dispute that QCI and the unaffiliated third party buyer are not public service corporations; they are foreign corporations that are not engaged in the provision of utility service in this State.[6] Accordingly, as interpreted by the *Arizona Supreme Court in Ariz.*

[6] The Commission's jurisdiction over non-public service corporations is limited by Sections 4 and 5 of

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Corp. Com'n v. State ex rel. Woods, 171 Ariz. 286, 830 P.2d 807 (1992), the Commission's Rules do not apply to this transaction.

Under *Woods*, the Rules do not extend the Commission's regulatory jurisdiction to parent holding companies and affiliates of public service corporations and to the approval of transactions involving only these parents and affiliates, irrespective of the local utility's involvement.

The Arizona Supreme Court upheld the validity of the Rules, reasoning that on their face, the Rules constituted a permissible exercise of the Commission's power to set rates and charges. *Woods*, 171 Ariz. at 299, 830 P.2d at 820. The Court was careful, however, to note that the Rules "apply only to public utilities subject to the Commission's jurisdiction," and that the rules "only regulate transactions between those utilities and their affiliates." *Id.* at 298, 830 P.2d at 819 (emphasis added). The Court's analysis was premised on the fact that the transactions to be regulated would directly involve the regulated utility, and on the Commission's corresponding statements concerning the limited scope and applicability of the Rules.

> The Proposed Rules arguably prevent utilities from endangering their assets *through transactions with their affiliates.* If such transactions damage a utility company's assets or net worth, the company will have to seek higher rates for survival. Thus, *transactions with affiliated corporations* could have a direct and devastating impact on rates. Given the framers' intent, historical background, and precedent, we believe the Commission's regulatory power permits it to require information regarding, and approval of, *all transactions between a public service corporation and its affiliates* that may significantly affect economic stability and thus impact the rates charged by a public service corporation.

Id. at 295, 830 P.2d at 816 (emphasis added).

The Court rejected arguments that the Rules might be used to "substantively control the broadest possible range of transactions, even when a utility affiliate may have no corporate connection with Arizona other than its corporate affiliation with the Arizona utility," stating,

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Article 15, and authorizes the Commission to investigate these entities only when they are offering their stock for sale to the public or concerning their qualifications to do business in Arizona. *See Arizona Public Service Co. v. Arizona Corp. Com'n*, 157 Ariz. 532, 534-35, 760 P.2d 532 (1988) *quoting Wylie v. Phoenix Assurance Co.*, 42 Ariz. 133, 136-37, 22 P.2d 845, 846 (1933).

"[w]e do not believe that the Proposed Rules have such sweeping effects." *Id.* at 298, 830 P.2d at 819. In support of this belief, the Court relied on the express language of the Rules themselves.

> *First, the rules, of course, apply only to public utilities subject to the Commission's jurisdiction.* Proposed Rule R14-2-802. They require information regarding diversification activities of those public utilities and their affiliates. See Proposed Rules R14-2-803 to R14-2-805. Further, the rules *only regulate transactions between those utilities and their affiliates.* See Proposed Rule R14-2-804.

Woods, 171 Ariz. at 298, 830 P.2d at 819 (emphasis added). Thus, as interpreted by *Woods*, the Rules apply only to public service corporations furnishing utility service in Arizona.[7] The Commission, therefore, cannot use its Rules to assert jurisdiction over this transaction and ignore the holding of *Woods*, and of the Arizona Court of Appeals in *U S WEST*, in an effort to undo the 1988 Settlement Agreement.

III. ASSUMING FOR THE SAKE OF ARGUMENT THE COMMISSION NONETHELESS DETERMINES THAT REVIEW AND APPROVAL OF THE SALE UNDER A.A.C. R14-2-803 IS PERMISSIBLE, IT SHOULD APPROVE THE SALE AS CONSISTENT WITH THE STANDARDS SET FORTH IN THAT RULE.

As described above, review of the Dex sale would exceed the Commission's authority under the Rules, as interpreted in by the Arizona Supreme Court in Woods. Moreover, the Rules do not provide any basis that would allow the Commission to avoid its commitment in the 1988 Settlement Agreement. Nor may the Commission superimpose the "public benefits" standard of A.R.S. § 40-285 on its Rules to achieve the same result. Assuming for the sake of argument the Commission determines that it does have jurisdiction to review the Dex sale transaction under the Rules, then it must do so under the 3-part standard it established in A.A.C. R14-2-803(C). As a matter of due process, the Commission cannot apply a standard not embodied in A.A.C. R14-2-803(C) if reviewing the sale transaction under that provision. See generally, *Mercy*

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[7] The Rules themselves limit their scope of application. For example, A.A.C. R14-2-802(A) provides: "These rules are applicable to all Class A investor-owned utilities under the jurisdiction of the Commission and are applicable to all transactions entered into after the effective date of these rules."

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Healthcare Arizona, Inc. v. Arizona Health Care Cost Containment System, 181 Ariz. 95, 887 P.2d 625 (citing *Maricopa County Juvenile Action No. JS-5209 & JS-4963*, 143 Ariz. 178, 183, 692 P.2d 1027, 1032 (App. 1984)); *Arizona Health Care Cost Containment System Administration v. Carondelet Health System* (Ariz. App. Div. 1, 1996), 188 Ariz. 266, 935 P.2d 844.

Through the promulgation of its Rules, the Commission has established the standard for reviewing transactions that fall with the purview of A.A.C. R14-2-803. Under the Rules, the Commission must approve a proposed transaction *unless* the evidence presented at hearing demonstrates one of the following:

1) The transaction would impair the financial status of the public utility;

2) The transaction would prevent the public utility from attracting capital at fair and reasonable terms; or

3) The transaction would impair the ability of the public utility to provide safe, reasonable and adequate service.

Unless the Commission determines that one or more of the three concerns set forth in the Rule are implicated, it must approve the transaction as in the public interest. For example, if a proposed formation or reorganization of a utility holding company would have a neutral impact on the affiliated Arizona utility, the Commission cannot reject the stock acquisition or use A.A.C. R14-2-803 as means for extracting "benefits" from the local utility and imposing conditions in exchange for granting approval.

The testimony of Qwest witness Peter Cummings demonstrates that none of the three concerns set forth in A.A.C. R14-2-803(C) are implicated by the Dex sale transaction, and underscores that completing the transaction, far from impairing Qwest's financial condition, should actually improve the financial status of both Qwest and its parent, QCI. Accordingly, even if the Commission finds that the sale to be a "reorganization," within the purview of A.A.C. R14-2-803, it should further find that there is no basis to reject the proposed reorganization pursuant to that rule.

A. <u>The Sale Will Not Impair the Financial Status of Qwest.</u>

As Qwest Witness Peter Cummings describes in his testimony, the sale of Dex is essential to the continued financial viability of both Qwest and QCI, Qwest's ultimate parent. Mr. Cummings' direct testimony, along with the direct testimony of Brian G. Johnson, which Mr. Cummings adopted, details how the Dex sale transaction was a critical component of QCI's strategy to de-lever its balance sheet, reduce debt, and improve its financial situation. Indeed, had QCI not been able to reach an agreement to sell Dex, it would likely have been unable to renegotiate its $4 Billion Amended Credit Facility, which would have matured in May 2003. BG Johnson Direct at 6-9. The Dex sale was integral to negotiating a revised credit arrangement, the Second Amended and Restated Credit Agreement, or ARCA, which averted bankruptcy by extending these maturities and relaxing certain debt-to-EBITDA ratio covenants under the Amended Credit Facility.

QCI has made significant progress toward reducing debt and improving its financial condition by negotiating the ARCA, closing the first phase of the Dex sale, and completing a private debt exchange in December 2002. QCI still needs the proceeds from the second half of the Dex sale, however, including Arizona, to further reduce debt to a more manageable level and meet significant upcoming maturities. Mr. Cummings outlined these upcoming maturities in his testimony. Cummings Direct at 21.

Mr. Cummings' testimony also establishes that Qwest's financial well-being is inextricably intertwined with the financial health of its parent, QCI. As QCI began to experience difficulty in rolling over short term, commercial paper so did Qwest. Cummings Direct at 10-11. Ultimately, both QCI and Qwest were effectively locked out of the commercial paper market, and remain so today. *Id.* As QCI's bond ratings degenerated, so did Qwest's; bond ratings for both QCI and Qwest ultimately declined into "junk" bond status, where they remain today. Cummings Direct at 11-12. A QCI bankruptcy could have serious financial repercussions for Qwest, as

Qwest would be subject to the bankruptcy court's jurisdiction as an asset of QCI. BG Johnson Direct at 13.

Staff, RUCO and DOD has each acknowledged the financial necessity of the Dex sale. Staff witness Michael Brosch testified that he "agree[s] with the testimony of Qwest witness Brian G. Johnson that the sale of Dex is important to the continued financial viability of Qwest and the parent company QCI." Brosch Direct at 41. The Direct testimony of DOD witness Richard Lee included the following question and answer:

> Q: DO YOU AGREE WITH QWEST'S POSITION THAT THE SALE OF DEX IS IN THE PUBLIC INTEREST?
>
> A: Yes. Qwest witness Maureen Arnold states that 'the sale of Dex serves the public interest, as it allows QCI to avoid bankruptcy.' (*citing* Arnold Direct at 15) The testimonies of Qwest witnesses Peter C. Cummings and Brian G. Johnson support Ms. Arnold's conclusion.

Direct Testimony of Richard Lee at 4. RUCO, too, acknowledged that Qwest's current liquidity problems would be relieved by the sale. Direct Testimony of Ben Johnson, Ph.D. ("Dr. Johnson Direct") at 41.

B. <u>The DEX Sale Will Improve, Not Impair, Qwest's Ability to Attract Capital at Fair and Reasonable Rates.</u>

The Sale will not increase Qwest's capital costs, and will not impair Qwest's ability to attract capital at fair and reasonable rates. In fact, the sale should improve Qwest's ability to attract capital, as demonstrated by the effect of the closing of the first portion of the Dex sale. As Mr. Cummings described in his direct testimony, the capital market reaction to the announcement of the Dex sale and the completion of the first phase (Dexter) has been positive. Qwest's credit spreads, and its cost of borrowing, have declined with the completion of the first phase of the Dex sale. Cummings Direct at 22-26.

Failure to close the second phase of the Sale, on the other hand, could seriously jeopardize QCI's and Qwest's financial health, and significantly impair Qwest's ability to attract capital at fair and reasonable rates. The bond rating agencies have observed that it is critical for QCI to complete the second phase of the sale, and have already factored the closing of the second phase of the sale into their current ratings for QCI and Qwest. Cummings Direct at 25-26. If the second phase does not close, or is delayed, QCI's and Qwest's bond ratings are likely to be downgraded (Cummings Direct at 26), resulting in increased capital costs to Qwest. Cummings Direct at 22-23. Mr. Cummings' testimony to this effect is uncontroverted.

C. The Sale Will Not Impair Qwest's Ability to Continue to Provide Safe, Reasonable and Adequate Service in Arizona.

The sale of Dex is in the public interest because it goes a long way toward improving QCI's financial stability over the next several years, allowing subsidiaries like Qwest greater access to capital markets and lower costs of capital. BG Johnson Direct at 11. By completing the Rodney portion of the Dex sale, QCI can focus on core telecommunications services and continue to maintain high levels of service quality. *Id.* Completion of the sale will help ensure Qwest's ongoing access to capital markets necessary for the creation and maintenance of Arizona's robust local telecommunications network. Arnold Direct at 20.

The financial health and viability of a public utility has always been a primary concern in the public interest. Arnold Direct at 14. The Arizona Constitution requires the Commission to establish rates for the companies it regulates based on the fair value of their rate base in order to ensure that they have the opportunity to earn a fair rate of return. *See Scates v. Arizona Corporation Commission*, 118 Ariz. 531, 578 P.2d 612 (App. 1978). Indeed, the announcement of the Dex sale and closing of the Dexter portion of the sale yielded an immediate benefit for Qwest – lower capital costs for both short-term and long-term financing. BG Johnson Direct at 23.

Qwest's ability to obtain financing on reasonable terms has a direct impact on its ability to maintain its local service network and service quality programs. Arnold Direct at 14. While the sale of Dex provides QCI and Qwest a short-term reprise from the financial weakness the companies experienced in 2002, closing the Rodney portion of the sale is necessary for QCI to implement other financial initiatives aimed at restoring the financial health of the company and its subsidiaries. Transcript of Proceedings at 115-16, Dex Proceeding.

IV. THE COMMISSION SHOULD ADOPT AND APPROVE THE STIPULATION AS CONSISTENT WITH THE PUBLIC INTEREST.

A. The Stipulation is a Fair and Reasonable Compromise of Disputed Issues, it More Than Adequately Satisfies Any Ratepayer Interest in the Directory Assets, and the Commission Should Adopt and Approve the Stipulation as Consistent with the Public Interest.

1. The amount of the benefits conferred by the Stipulation is fair.

a. The Stipulation provides a significant increase over current imputation.

The Stipulation provides for an increase in imputation from $43 million per year, its current and presumptive level, to $72 million per year. This increased imputation amount would apply for 15 years, at which point imputation would end. This increased imputation amount confers upon ratepayers a significant and palpable benefit in the form of a diminished Qwest revenue requirement, in the event of any future rate case or other rate proceeding, during that 15 year period.[8] Absent the Stipulation, it is most likely that the imputation amount would remain at $43 million per year in a future rate proceeding. While this issue has been the subject of much debate and even litigation in rate cases subsequent to the 1988 Settlement Agreement, the imputation amount has remain fixed at $43 million per year in each of these proceedings.

At hearing, RUCO witness, Dr. Johnson, contended that it was not possible to determine what level of imputation is currently in rates. This contention cannot withstand scrutiny. The testimony in the 1999 rate case, which led to the adoption of the current Price Cap Plan, and the

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[8] DOD suggests that the Stipulation is not fair and reasonable because the net present value of the Stipulation is not at the mid-point of the net present values for the various proposals made by the parties. Rejoinder Testimony of Richard Lee at 3-4, and schedule RBL-1. The fairness and appropriateness of any settlement cannot be determined by simply focusing on the mid-way point between the parties' opening offers. Evaluation of a settlement requires the consideration of many factors, including litigation risks, which Staff undertook in reaching this Stipulation.

discussion during the open meeting at which the Commission adopted and approved that Plan, demonstrate that all parties, as well as the Commission, understood that imputation was remaining fixed at $43 million per year. *See* Discussion, Section I(D), *supra.* at 8-11. Mr. Lee, DOD's witness, testified that $43 million had, for all intents and purposes, been the amount of directory imputation since 1988 and that $43 million was the amount included in the price cap plan. Transcript of Proceedings at 33, Dex Proceeding. It is also clear that imputation ultimately was set at $43 million per year in the previous 1993 rate case, after the Arizona Court of Appeals remanded that case to the Commission and expressly directed that imputation be set at $43 million per year in that case on remand. *See* Discussion, Section I(C), *supra.* at 8. Dr. Johnson's claim that the current imputation amount cannot be determined is nothing more than revisionist history. The imputation currently in Arizona rates is $43 million/year, and must remain at that level in a future rate proceeding – absent adoption and approval of the Stipulation – unless a party were able to demonstrate that the value of fees and services provided by the directory publisher to Qwest is some different amount. To date, at least, no party has ever been able to make such a showing.

Staff tried to change the present imputation amount in the 1993 rate case, arguing for a $17.6 million increase in imputation based on the excess profitability of the directory operations over the return allowed USWC for its regulated operations. The Arizona Court of Appeals found that such an approach was impermissible and in clear violation of the 1988 Settlement Agreement. During the 1999 rate case and Price Cap Plan proceeding, Commissioner Spitzer inquired whether imputation could be increased based on change in the Consumer Price Index ("CPI") since the 1988 Settlement Agreement. Both Staff witness Michael Brosch and Commission Chief Counsel Chris Kempley advised the Commission that imputation could not be set by relation to the CPI or the change in the CPI since 1988, because such a change is barred by the 1988 Settlement Agreement and the Arizona Court of Appeals Opinion definitively interpreting that agreement. The imputation amount may only be revised based on a showing as to value of fees and services provided to Qwest by its directory publisher.

For this reason, Dr. Johnson's suggestion that the imputation amount should be increased in this proceeding, based on access line growth and inflation, fails as a matter of law. As Dr. Johnson acknowledged in the hearing, nowhere does the 1988 Settlement Agreement provide for changes to the imputation amount based on access line growth. Transcript of Proceedings at 287-288, Dex Proceeding. Nowhere does the 1988 Settlement Agreement provide for changes in the imputation amount based on inflation (which, for all practical purposes, is indistinguishable from the CPI approach considered and rejected in the 1999 Price Cap proceeding as inconsistent with the 1988 Settlement Agreement). *Id.* at 289-290.

Dr. Johnson readily admits that the 1988 Settlement Agreement would continue to apply absent adoption of the Stipulation. *See* Transcript of Proceedings at 323-24, Dex Proceeding; Dr. Johnson Direct at 45. The 1988 Settlement Agreement provides that the imputation amount may only be changed: 1) in future rate proceedings; and 2) based on the value of fees and services provided by the directory publisher. This case is neither a rate proceeding nor is Dr. Johnson's proposal in any way based on the value of directory fees and services. Accordingly, his proposal is both impermissible and premature under the 1988 Settlement Agreement. Absent an agreement to increase the imputation, as embodied in the Stipulation at issue here, the Commission cannot increase the imputation benefit until there is a rate proceeding in which the value of fees and services is demonstrated to be something other than $43 million. Indeed, Mr. Brosch testified that directory revenue imputation would have grown in Arizona after 1988 *except* for the 1988 Settlement Agreement. *Id.* at 204-205. What Mr. Brosch recognizes and Dr. Johnson ignores is that the 1988 Settlement Agreement limits imputation to the value of fees and services received by Qwest from the directory publisher. Under the 1988 Settlement Agreement, imputation does not grow with inflation or access line growth; it increases or decreases when evidence is presented in a rate case that the value of fees and services have gone up or down. Nothing in Dr. Johnson's testimony makes such a showing.

Similarly, many of Mr. Lee's criticisms of the amount of imputation under the Stipulation are really arguments that the imputation set in the 1988 Settlement Agreement is insufficient. As noted above, Mr. Lee does not quarrel with the fact that (1) the presumptive amount of imputation under the 1988 Settlement Agreement is $43 million and (2) $43 million of the directory revenue imputation is embedded in Qwest rates under the Price Cap Plan. *See* Transcript of Proceedings at 32-33, Dex Proceeding. Indeed, he testified that he imputed $43 million in directory revenues in his own testimony filed in the Price Cap Plan proceedings. *Id.* His criticisms that the Stipulation is not in the public interest because present imputation is inadequate miss the point.

Staff witness Brosch testified that absent the 1988 Settlement Agreement, directory revenue imputation would be higher. Transcript of Proceedings at 205, Dex Proceedings. However, he also stated that the ability to raise directory revenue imputation in Arizona absent this Stipulation is constrained by the 1988 Settlement Agreement. *Id.* Brosch further testified that, taking into account all of the litigation risks factors, including the impact of the 1988 Settlement Agreement, the Stipulation is fair and in the public interest. *Id.* at 175-176. Brosch's analysis based on a careful, considered assessment of the 1988 Settlement Agreement is much more persuasive than Mr. Lee's approach of ignoring that agreement or complaining as to its inadequacy.

For these reasons, the $29 million increase in annual imputation pursuant to the Stipulation does represent a concrete and significant ratepayer benefit. The increased imputation amount will immediately be captured in Qwest's July 1, 2003 Price Cap filing, pursuant to the terms of the Stipulation.

b. The Stipulation is fair and reasonable under gain-sharing principles.

The total benefits conferred by the Stipulation are also more than reasonable from a traditional gain-sharing perspective. Qwest identified the portion of the gain that relates to Qwest's directory obligations in Arizona and the portions of the gain that must be excluded from any gain sharing consideration because they are not related to those publishing obligations.

Surrebuttal of Ann Koehler-Christensen ("Koehler-Christensen Surrebuttal") at 9-17. Qwest's calculation of the gain in Arizona with adjustments to remove the portions that are not associated with Qwest's publishing obligations in Arizona yields a post-tax gain in Arizona of $414.8 million post-tax. Koehler-Christensen Surrebuttal, AKC-S2; Grate Surrebuttal, PEG-S4 at 1. When multiplied by a 1.65371 income tax gross-up factor, the $414.8 million post-tax gain equals a pre-tax gain of $686.0. *Id.* The net present value of $72 million of imputation for 15 years, using the mid-year convention and a discount factor of 8.29%, is $630.25 million. Grate Surrebuttal, PEG-S4 at 2. Hence, the Stipulation provides for an imputation amount with a net present value equal to 92% of the Arizona portion of the pre-tax gain, as calculated by Qwest. $630.25 million is also 61 % of $1,040.5 million, the Arizona portion of the pre-tax gain calculated by Staff. Direct Testimony of Michael Brosch, Attachment MLB-1 at 1. It is more than 50% of the net present value of any of the gain calculations made by DOD.[9] *See* Lee Rejoinder Testimony, Schedules RBL-1, 4, 5, and 6. Certainly it is not 100% of the Arizona portion of the gain, as DOD witness Lee argues for[10] – but Arizona ratepayers are not entitled to 100% of the gain for several reasons.

First, and foremost, the 1988 Settlement Agreement specifies the directory related benefits that ratepayers are entitled to receive; namely, that the value of fees and services provided by the

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[9] RUCO witness Johnson did not prepare or rely on any gain calculation. Transcript of Proceedings at 296, Dex Proceeding.

[10] Mr. Lee recommended that the gain be calculated on a pre-tax basis rather than a post-tax basis because QCI will pay no income taxes on the gain from the sale of Dex due to deductions of net operating losses from unregulated operations. His assertion is based on two fallacious income tax accounting principles. The first is that the tax cost of a given period is equal to the amount of taxes paid to taxing authorities during that period. The second is that the measurement of cash taxes should be based on consolidated cash taxes, i.e. the taxes paid by the parent corporation filing a consolidated income tax return. However, neither of these principles is accepted under Generally Accepted Accounting Principles, nor incorporated into the FCC's Uniform Systems of Accounts. See 47 CFR § 32.22, Comprehensive Interperiod Tax Allocation. Instead the gain, as determined under Internal Revenue Code ("IRC") Section 1001, is taxable under IRC section 61. Nothing in the IRC or the federal income tax regulations allows a deduction against the gain of Dex for net operating loss carry-forwards or from losses incurred on sales of other companies, such as LCI. If QCI does not pay cash taxes to the IRS in 2002 or 2003, it will be because of tax savings from other tax events that occurred either in the current period or in the past, not because the sale of Dex went untaxed.

directory publisher will be included in arriving at Qwest's test year operating income in future rate proceedings. It is, in other words, imputation in an amount equal to the value of such fees and services. Nowhere does the 1988 Settlement Agreement provide that this arrangement shall end upon the sale of the directory operations to a third party, and indeed, Dr. Johnson acknowledged that the 1988 Settlement Agreement would continue to apply after the sale. *See* Transcript of Proceedings at 302, 323-24, Dex Proceedings; Dr. Johnson Direct at 45. The 1988 Settlement Agreement does not provide that ratepayers shall receive 100% of the gain upon a future sale of the directory operations.

Further, DOD witness Richard Lee provides no support for his advocacy that ratepayers must receive 100% of the gain on sale, other than his nebulous contention that Judge Greene "gave" the directory operations to ratepayers in the Modified Final Judgment to serve as a source of subsidy for basic local rates. This contention is flawed for a host of reasons. To begin with, the Modified Final Judgment has been vacated, and is no longer the law. *See* Grate Surrebuttal at 21. In any case, Judge Greene did not indicate in the Modified Final Judgment that he sought to create a perpetual subsidy for local exchange services. Indeed, the subsidy issue was not even the primary basis on which Judge Greene based his decision to have directory operations remain with the local operating companies. *See* footnote 2, *infra.*; *see also,* Grate Surrebuttal at 21.

Even if one accepts that directory operations were awarded to the BOCs to serve as a source of contribution to basic local exchange services, this merely establishes that directory operations bear a relationship to local exchange services, as previously held by the Commission. See Decision No. 55755 at Discussion ¶ 1. It is this relationship that opens the door to a discussion on gain-sharing between ratepayers and shareholders. Had the directory operations never been conducted by the regulated utility, there would be no basis to even consider the gain-sharing question. It is well settled that ratepayers have no claim to gain on disposition of non-utility assets. *See Democratic Central Committee v. Washington Metropolitan Transit Commission*, 458 F.2d 786, 806 (D.C. Cir. 1973), *cert. denied,* 415 U.S. 935 (1973).

Merely concluding that directory operations are a utility asset because they were provided by the utility before 1984, does not mean, however, that 100% of the gain on sale of the directory publishing business today belongs to ratepayers. That is not, and has never been the law in Arizona. Certainly directory operations can be no more a "utility asset" than telephone exchanges, including switches and loops. One cannot make a telephone call without switches and loops, but certainly one can make a telephone call without a directory. Yet it has never been the case that 100% of the gain on sale of utility assets such as switches, loops, entire telephone exchanges or other assets of a regulated public service corporation belongs, as a matter of course, to ratepayers.[11] In Decision No. 63268 (December 15, 2000), the Commission did not require that 100% of the gain that Qwest would receive from the sale of those exchanges be assigned to the ratepayers. Further, the Commission has historically applied a 50/50 split between ratepayers and shareholders on the sale of clear cut utility assets such as streetlights owned by an electric utility.[12] Precedent does not support assigning 100% of the gain from a sale of assets to the ratepayer even when those assets are clearly utility assets.[13]

The seminal case on the sharing of gains from a sale of utility assets between the ratepayers and the shareholders is *Democratic Central Committee of the Dist. of Columbia v Washington Metro. Area Transit Comm'n,* 158 U.S. App. D.C. 7, 458 F.2d 786 (D.C. Cir. 1973), *cert. denied,* 415 U.S. 935 (1973)[14]. *Democratic Central Committee* does not hold that ratepayers

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[11] *See* Decision No. 63268 (December 15, 2000), *In the Matter of the Joint Application of U S WEST Communications, Inc. and Citizens Utilities Rural Company, Inc. for Approval of the Transfer of Assets in Certain Telephone Wire Centers to Citizens Rural and the Deletion of Those Wire Centers from U S WEST's Service Territory*, Docket Nos. T-01051B-99-0737 and T-01954B-99-0737 (consolidated); Decision No. 62672 (June 30, 2000), *In the Matter of the Merger of the Parent Corporations of Qwest Communications Corporation, LCI International Telecom Corp., USLD Communications, Inc., Phoenix Network, Inc. and U S WEST Communications, Inc.*, Docket No. T-01051B-99-0497.

[12] Decision No. 55228, Docket No. U-1345-85-156.

[13] DOD's witness, Mr. Lee, conceded that he made no review of past Commission precedent on gain sharing in making his recommendation that ratepayers be allocated 100% of the gain. Transcript of Proceedings at 26, Dex Proceeding.

[14] It is important to note that while Mr. Lee disagreed with Qwest's interpretation of *Democratic Central Committee,* he agreed that this case set forth the principles governing gain sharing. Transcript of Proceedings at 24-25, Dex Proceeding.

are entitled to 100% of the gain on sale from utility assets; nor does it hold that shareholders are entitled to 100% of the gain. Rather, it stands for the proposition that such gain properly belongs to the party that bore the risk of capital loss with regard to the asset in question, or, if that determination cannot be made, to the party who bore the burden of the utility activity in question. *Id.* at 806.

Qwest witness Grate is the only witness who undertook such a risk and burden analysis, which demonstrated that ratepayers have not borne a risk of capital loss or the burden of the cost recovery on directory operations.[15] Mr. Grate's testimony showed that Arizona directory operations were developed in late 1800s, long before advent of cost-of-service regulation in AZ. Further, since at least 1925, directory operations have always been profitable, and therefore represented no burden to ratepayers. Grate Surrebuttal at 18. In the post-divestiture/imputation era, the 1988 Settlement Agreement clearly prevented any risk of capital loss or burden of cost recovery from being imposed on ratepayers. As a consequence of the 1988 Settlement Agreement, ratepayers have received a steady and unchanging benefit – not burden – in the form of a $43 million annual subsidy to rates for local exchange services.

Mr. Grate's careful risks/burden analysis, which reviewed the history of regulation of directory operations and the financial performance of directory operations in Arizona since their inception, demonstrates that, under a *Democratic Central Committee* gain-sharing approach, ratepayers are entitled to receive none of the gain on the sale of the directory operations. Nonetheless, as previously noted, the Stipulation provides to ratepayers a substantial percentage of the Arizona portion of the gain under any calculation of the gain.[16] However, the Commission need not agree with Mr. Grate's analysis, or even directly reach the issue of an appropriate

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[15] Mr. Lee conceded that he did not evaluate the relative burdens and risks borne by ratepayers and shareholder with respect to the directory publishing business in making his recommendation that 100% of the gain be allocated to ratepayers. Transcript of Proceedings at 24-26, Dex Proceeding.

[16] Again, it is important to note that RUCO witness Johnson did not calculate an amount of gain from the sale but based his recommendation on increased imputation independent of the gain amount. Transcript of Proceedings at 22, Dex Proceeding.

sharing of the gain. The salient points here are: 1) no party offered any persuasive evidence or analysis to support the proposition that 100% of the gain should be given to ratepayers; 2) the litigation risk that ratepayers are entitled to something less than 100%, is something that Staff should have, and indeed, did consider in agreeing to the Stipulation. Transcript of Proceedings at 208-209, Dex Proceeding.

c. The Stipulation is reasonable and fair in light of the litigation risks in this proceeding.

The ratepayer benefits conferred by the Stipulation are also more than reasonable when viewed against the backdrop of the litigation risks associated with this docket. Staff testified that these risks include: 1) an appellate determination that Commission jurisdiction does not exist; 2) a determination that the Commission's authority is limited by 1988 Settlement Agreement; and 3) meaningful disputes concerning the method of calculating and allocating the gain (i.e., determining the appropriate amount of any ratepayer benefit in the event that the 1998 Settlement Agreement did not limit that benefit to imputation of the fees and value of services received by Qwest). Transcript of Proceedings at 178-179, Dex Proceeding. In light of the possibility that the Staff could lose on one or more of these issues if the matter were litigated on appeal, Staff determined that the Stipulation represented a reasonable compromise of any ratepayer interest in this proceeding. *Id.* at 176. RUCO witness Johnson further acknowledged that a settlement of this nature should not be considered in a vacuum. Transcript of Proceedings at 334-337, Dex Proceeding. If a person told Dr. Johnson that he or she settled a case for $100,000, Dr. Johnson could not tell whether it was good or bad settlement without knowing a number of things, including the chance of prevailing on the underlying claim (i.e., litigation risk). *Id.*; *see also*, Transcript of Proceedings at 387-397, Dex Proceeding.

In evaluating whether the present value of the imputation provided for in the Stipulation is fair and reasonable, it is necessary to focus on the litigation risk faced by Staff in deciding to enter into the Stipulation. It is simply not possible, as RUCO witness Johnson acknowledged, to assess whether a settlement is reasonable devoid of any meaningful consideration of litigation risk. So, in evaluating whether or not $ 72 million in imputation for 15 years (a present value of $630 million) would be a reasonable settlement of the Docket, Staff was required to evaluate the strong possibility that ratepayers would receive less if the Application were litigated or ultimately appealed.

First, Staff faced the risk that the Commission lacks jurisdiction to approve or disapprove a transfer of the directory assets in light of (1) the 1988 Settlement Agreement, (2) the inapplicability of A.R.S. § 40-285, and (3) the inapplicability of the Commission's Affiliate Rules. These issues have been discussed previously in this brief and will not be repeated here. A ruling that this Commission lacks jurisdiction would mean that ratepayers would receive no benefit other than what they already receive under the 1988 Settlement Agreement – a benefit that may be not only lower but also less certain than the benefits achieved by the Stipulation.

Second, Staff faced the risk that even assuming for the sake of argument that the Commission had jurisdiction over the Application, it would ultimately be held that the ratepayers had already received any benefit to which they were entitled by virtue of the 1988 Settlement Agreement. Again, these points are discussed elsewhere in this brief. In the face of such a ruling, the ratepayers would be significantly less well off than they are under the Stipulation.

Third, assuming for the sake of argument that the Commission had jurisdiction over the transaction and its review were not limited by the 1988 Settlement Agreement or A.A.C. R14-2-803, Staff faced the issue of the amount of the gain properly attributable to Arizona for appropriate allocation between shareholders and Arizona ratepayers. Litigation of this issue could have resulted in less gain being available to Arizona ratepayers. Qwest's witness Ann Koehler-Christensen testified that Staff, DOD and RUCO improperly included in their advocacy positions gain that was not attributable to the directory publishing operations transferred from Mountain Bell to USWD in 1984. *See* Surrebuttal Testimony of Ann Koehler-Christensen at 5. Because the primary basis for any claim that the ratepayers are entitled to any gain from the sale is the assignment of the directory publishing operations to Mountain Bell in 1983, and its transfer of those operations to an affiliate in 1984, only that portion of the gain that is attributable to the operations transferred is subject to any claim by ratepayers.[17] The lines of business developed by Dex since 1984 are not and cannot be the property of the ratepayers. *See* Surrebuttal Testimony of Ann Koehler-Christensen at 12, 20. These newly developed lines of business accounted for a significant portion of the gain on the Dex sale and are not available for sharing with ratepayers.

Fourth, Staff faced the issue of allocation of the Arizona gain between ratepayers and shareholders discussed above. Neither traditional *Democratic Central Committee* gain sharing principles nor Arizona precedent supports assigning 100% of the gain to ratepayers and Staff had to evaluate that precedent in determining an amount that could reasonably be recovered for the ratepayers through litigation and a potential appeal.

As discussed above, Mr. Brosch testified that Staff considered all of these factors in light of the regulatory history surrounding the directory operations in Arizona and concluded that the imputation amount under the Stipulation was fair, reasonable and in the public interest. This conclusion is fully supported by the record in this case.

2. The Manner and Term of the Stipulation is Fair and Reasonable.

The 15-year term contained in the Stipulation is reasonable because it maintains rate stability while increasing the imputation benefit for the foreseeable future. Qwest, Staff and DOD each proposed imputation over a 15-year period from the approval of the Application.

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[17] Mr. Lee, in fact, acknowledged that ratepayers could only have a claim against gain attributable to directory operations assigned to the BOCs at divestiture in 1984: "If a portion of the gain was unrelated to the directory subsidy ordered by Judge Green [sic], essentially, at divestiture, such as LCI, if there was some gain to show up from that, I would say it shouldn't be handled as part of the subsidy to go to ratepayers." Transcript of Proceedings at 17, Dex Proceeding. In fact, Ms. Koehler-Christensen's calculation of the Arizona gain subject to sharing with ratepayers excluded only those sales proceeds attributable to revenues entirely unrelated to the directory subsidy ordered by Judge Greene at divestiture. Ms. Koehler-Christensen excluded gain associated with Dex's internet/new ventures line of business, secondary directories, and non-Qwest customer listings in Qwest primary directories. Ms. Koehler-Christensen testified that none of these existed in 1984, at divestiture, and her testimony is unrefuted. Koehler-Christensen Surrebuttal at 4. Indeed, it cannot be refuted because these components of the directory business simply did not exist in 1984. They cannot, by definition, be related to the subsidy ordered by Judge Greene in 1984 because they did not exist in 1984. Based on the standard advanced by Mr. Lee himself, then, they must be excluded from any calculation of gain subject to sharing with ratepayers.

DOD witness Lee explained his selection of 15 years as the imputation period by testifying that it is difficult to predict what form of regulation will exist in Arizona beyond the next 15 years:

> A. We could have suggested that it be amortized over 50 years or 30 years or any number of years. We chose, as I discussed in my rebuttal, 15 years, because we don't believe that revenue requirement calculations will have meaning beyond the next 15 years. Indeed, they may not have, as I said before, meaning beyond this year. It's a fair statement that we don't believe, or I don't believe that it would have meaning after 15 years.
>
> Q. Can you tell me why, if you don't believe it would have meaning after 15 years?
>
> A. Because I think that in some way – some fashion or another, competition will come to local telecommunications.

Transcript of Proceeding at 18-19, Dex Proceeding.

Staff Witness Brosch agreed with this assessment:

> Q. Okay. And would you agree with me that customers would be better off if the $72 million lasted for 20 years instead of 15 years?
>
> A. I don't know. I don't think that's knowable. One has to presume something about the state of regulation in Arizona 15 years into the future to foresee whether it would make any difference.
>
> Q. Would you answer be the same if I asked you 15 years as opposed to 50 years?
>
> A. Yes, I think it's very difficult to imagine traditional regulation that distant into the future.

Transcript of Proceeding at 211, Dex Proceeding.

If the total benefit provided by the Stipulation were spread over 40 or 50 years, to match the term of the Publishing Agreement, then either the benefit amount, the benefit period or both would need to be reduced. As an illustrative example, using simple math, if given an option of being paid $1,000 annuity spread over ten years ($100 per year) as opposed to over 50 years ($20 per year), most individuals would choose the shorter term because: 1) the $1,000 would be recovered more quickly; and 2) its net present value is higher with the shorter term annuity. *See*

Transcript of Proceedings at 308-309, Dex Proceeding. The recipient could protest (much as Dr. Johnson does here) that he does not wish to receive $100 for ten years or $20 for fifty years but instead he wishes to receive $100 for fifty years. That, of course, would change the total value of the annuity, and that is precisely the point here. *Id.* at 314-315. This sort of change in the annuity (or settlement) can only be achieved by agreement of the parties to increase the total value of the annuity (or settlement). If the Stipulation were altered so that the period of imputation were lengthened while the net present value of the Stipulation did not change, the amount of annual imputation would have to be reduced. Both Staff and DOD recognized this simple truth. As Staff witness Brosch explained:

> Q. And can you tell me why you would agree or Staff agreed to the 15 years as opposed to the 20 years, especially if it didn't matter?
>
> A. Again, that was part of the compromise that was reached. The trade-off that is faced is if you add more revenue credit years to reach 20 or 50, using your examples, you dilute the value available in the early years under the presumption that there's only so much value that can go to customers form the deal. If you fix the dollar amount and spread it 50 years into the future, you may end up closer to 43 than 72.

Id. at 211.

Mr. Lee further explained that:

> If we had chosen a longer period of amortization, the value, the present value of the first years and certainly for the 15 years would have been less, because in our way of looking at the case, we start with a fixed value, which is to be distributed in some way to local ratepayers.

Id. at 18.

Similarly, the great weight of the testimony is that continued imputation is more appropriate than either immediate bill credits alone or bill credits coupled with lower imputation. Each dollar that is subtracted from the net present value of $630 million to distribute as immediate credits requires either less annual imputation or a shorter term to receive the same benefit under the Stipulation. Mr. Brosch clearly stated that "if a one-time bill credit, had been included in the Arizona stipulation, lower annual revenue credits [imputation] would have been necessary that would be disadvantageous to ratepayers in the future." Transcript of Proceedings at 185, Dex Proceeding. Mr. Brosch also indicated that bill credits were more appropriate in a state like Washington, which had a higher pre-settlement level of imputation. *Id.* at 186. Given these considerations, Staff made a determination that the 15-year imputation period at the $72 million level achieved the optimum benefit for ratepayers. Further, Dr. Johnson indicated that RUCO did not recommend an immediate bill credit. Transcript of Proceedings at 281, Dex Proceeding.

B. <u>The Arizona Stipulation is Fair and Reasonable in Comparison to the Utah Settlement and Proposed Washington Settlement</u>.

During the course of the hearing, the issue arose as to whether the Stipulation was reasonable in light of the settlements reached by Qwest in Utah and Washington. The record clearly establishes that when the increase in imputation in the Stipulation is compared with the bill credits in the Utah settlement and the bill credits and increased imputation in the proposed Washington settlement, the Arizona Stipulation is fair, reasonable and in the public interest.

Any comparison of the settlements in the three states must take into account a number of factors:

1) Different starting points for settlements in each state;

2) Differing legal precedent and forms of regulation;

3) The amount of gain available from the sale in each state; and

4) The timing of when ratepayers are likely to see the benefits of increased imputation reflected in rates.

Transcript of Proceedings at 388, Dex Proceeding.

1. Different Starting Points for the Settlements

In comparing the settlements, it is important to focus on what each state's ratepayers received in that state's settlement over the benefits those ratepayers were already receiving under the status quo. In order to properly compare the reasonableness of the Arizona settlements to those in other states, it is necessary to compare the change in the amount of imputation, as well as any applicable bill credits that result from the settlement in each state, rather than the gross amount of imputation in each state.

On cross-examination, RUCO witness, Dr. Johnson, essentially conceded that until such beginning positions are known and accounted for, one could not determine which settlement provides greater benefits.

> Q. All right. I have another hypothetical for you. Assume that my son and daughter each have a bank account, all right? I add enough money to my son's account to bring it to $300.
>
> A. Again, the numbers?
>
> Q. They each have a bank account. I add enough money to my son's account to bring it to $300.
>
> A. Okay.
>
> Q. I add enough money to my daughter's account to bring it to $200.
>
> A. Okay.
>
> Q. Who just got more money, my son or daughter?
>
> A. I don't know.
>
> Q. Why don't you know?
>
> A. Because you didn't tell me how much was in each account before you added to it.

Id. at 337-338.

Qwest's last rate case in Arizona imputed a presumptive amount of $43 million in directory revenues based on the 1988 Settlement Agreement and subsequent case law. *See* Section I *supra*. By contrast, Qwest's last retail rate proceeding in Washington took place in

1997. In that rate case, the Washington Utilities and Transportation Commission (WUTC) imputed $85.2 million in directory revenue to Qwest. Transcript of Proceedings at 390, Dex Proceeding. On a going forward basis, Qwest periodically calculates and reports a current imputation amount in Washington. Qwest reported a calculated imputation of $103.4 million for 2001 based on a WUTC prescribed methodology. *Id.*

In comparing the reasonableness of the two settlements as a compromise of disputed issues, it is necessary to compare the increase in imputation - not the absolute amounts - relative to the status quo in each state. The Arizona Stipulation provides for a $29 million increase to directory imputation for the next 15 years – roughly a 67% increase over what is currently imputed. The Washington settlement provides for a one-time bill credit of $67 million, and revenue credits of $110 million during the first 4 years of the 15-year term – roughly a 9.5% increase. For the remainder of the term, revenue credits are set at $103.4 million – the amount of imputation reported by Qwest in 2001. Mr. Grate testified that, from the perspective of change on the status quo, the net present value of the Arizona Stipulation significantly exceeded the net present value of the Washington settlement based on 2001 reported Washington imputation. He also testified that the Stipulation was virtually identical to the net present value of the Washington settlement based on the imputation level included in the last Washington rate case.[18] *Id.* When compared to the Washington settlement, the Stipulation provides a higher net present value of *increased* imputation than does the Washington settlement of increased imputation and bill credits.[19]

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[18] Dr. Johnson and Mr. Lee suggest that the Washington Settlement is more beneficial to ratepayers than the Stipulation. They are wrong. While the gross amount of imputation in Washington on a going forward basis exceeds the gross amount in Arizona, the difference in gross amount already exists, and is attributable to the respective status quo in each state. That difference is a function of the different regulatory history in each state. *See* Transcript of Proceedings at 186-87, Dex Proceeding.

[19] Qwest Exhibits Q-10 and Q-11, Mr. Grate's comparison of the present value of the Stipulation and the Washington settlements, reflects the present value of each of these settlements over continued imputation at current levels for fifteen years. Mr. Grate prepared the exhibits in this manner so that there could be a direct comparison between the two settlements. Qwest's supplemental exhibit filed after the hearing compares the Stipulation to the status quo based on the assumption that imputation and the 1988 Settlement Agreement could continue to fifty years or indefinitely.

Similarly, the Stipulation compares favorably against the settlement already approved by the Utah Public Service Commission. That settlement provides a one-time bill credit equal to $22 million, with no adjustment of the imputation amount for rates. Additionally, based on different legal precedents in Utah, there is no possibility of adjusting the amount of imputation because Qwest is subject to permanent price-cap regulation. *Id.* at 391-392. The net present value of the Stipulation far exceeds the net present value of the bill credits in Utah.

2. Different Legal Precedents and Forms of Regulation

In comparing the settlements, it is important to understand the regulatory framework in each state and the precedent in each state that affects litigation risk.

Utah has adopted permanent price cap regulation. An increase in imputation is irrelevant in Utah. For that reason, the settlement there is focused solely on immediate customer credits.

Washington statutes, rules and court decisions concerning directory imputation are significantly different than the 1988 Settlement Agreement and the Arizona Court of Appeals decision interpreting that agreement. Staff's witness Brosch, who participated in both the Arizona and Washington Dex dockets testified that the Stipulation was fair to Arizona ratepayers when compared to the Washington Settlement in light of the different regulatory histories in the two states. Transcript of Proceedings at 177-179, Dex Proceeding.

3. The Amount of the Gain Available in Each State

In evaluating all three settlements (Arizona, Washington, Utah), it is important to recognize that each state's portion of the Dex sale differs. Ms. Koehler-Christensen testified that Qwest performed its allocation of gain among the states based on revenues within the State from directory advertising derived from Qwest customer listings in Qwest primary directories. Ms. Koehler-Christensen further testified that on that basis, Washington produces the most revenues of the three states and Utah produces the least. Therefore, any comparison of the total amount or total increase in imputation contained in these settlements must be weighed relative to the revenue in each state.[20]

4. The Immediacy of the Benefit to Ratepayers

Clearly, the Utah ratepayers and the Washington ratepayers will receive their benefits in different time frames than the Arizona ratepayers. Both of those states' ratepayers will receive the bill credit portion of their settlements in the near future. However, the immediacy of the imputation benefit to ratepayers in Arizona differs significantly from the immediacy of the imputation benefit to the Washington ratepayers. In Arizona, Qwest must file for a renewal or change in its Price Cap Plan by July 1 of this year. Under the Stipulation, the increased imputation of $72 million would be included in the filing, and would take effect in early 2004. The ratepayers will benefit from the increase in imputation very quickly in Arizona. *See* Transcript of Proceedings at 198-99, Dex Proceedings. Mr. Brosch explained this benefit in the following terms:

> We do know, I think, that we'll be $29 million better off in terms of revenue requirement, irrespective of one's view of achieved returns or appropriate authorized returns, and I expect that 29 million to be the subject of some dialogue in the review of the price cap plan.

Transcript of Proceedings at 199, Dex Proceeding. By contrast, Qwest is under a rate case moratorium in Washington until 2004 and has no obligation to file for rate review at any specific time. While the Washington ratepayers will undoubtedly benefit from increased imputation under the Washington Settlement, the benefit to the Arizona ratepayers is more immediate and more certain.

Applying all of these factors, the Stipulation compares favorably with the Washington Settlement and the Utah Settlement.

Finally, the Stipulation is superior to the status quo (1988 Settlement Agreement) in

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[20] Dr. Johnson's allocation between Arizona and Washington based on the number of access lines in each state is wholly inappropriate. As Ms. Koehler-Christensen explains in her surrebuttal, allocation of the gain by any of the states should be based on revenues from Qwest customer listings in Qwest's primary directories. *See* Surrebuttal of Ann Koehler-Christensen at 8.

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Arizona. Qwest's supplemental exhibit filed on June 3, 2003 demonstrated that the net present value of the Stipulation exceeds the net present value of continued imputation of $43 million for 50 years or out into the indefinite future. Further, the Stipulation is superior to the status quo because it provides Arizona ratepayers with stable, tangible and increased imputation benefits ($72 million) for the next 15 years when it is most likely to be relevant – as opposed to a presumptive imputation of $43 million subject to various litigation risks. And while both parties may litigate the fees and value of services during future rate cases or through judicial review of Commission decisions based on the 1988 Settlement Agreement, the Stipulation provides "certainty and finality to a controversial element of Qwest regulation" and recognizes the historical benefits received by Arizona ratepayers as a result of the directory business. *See* Brosch Supplemental Testimony at 3.

CONCLUSION

The Stipulation between Qwest and Staff represents an equitable and timely resolution of the issues surrounding QCI's sale of DEX. The transaction is critical to Qwest's long-term strategy for restoring its financial health, and provides a 67% increase in the benefits already accorded to Arizona ratepayers under the 1988 Settlement Agreement and current Price Cap Plan. Protracted litigation between the Commission and Qwest is a bleak alternative at a time when utilities and regulatory agencies should be working together in tackling the difficult issues at hand. In doing so, the Commission is charged with the responsibility of balancing the interests of ratepayers and utilities it regulates – a fair and equitable balance which Qwest and Staff believe is represented in the Stipulation.

DATED this 24th day of June, 2003.

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