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BEFORE THE ARIZONA CORPORATION COMMISSION

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Arizona Corporation Commission
DOCKETED
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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 QWEST DEX, INC.

DOCKET NO. T-01051B-02-0666

STAFF'S POST-HEARING BRIEF

I. INTRODUCTION

Qwest Communications International, Inc.'s ("QCI"), Qwest Services Corporation's ("QSC") and Qwest Corporation's ("Qwest") (collectively "the Companies") sale of Qwest Dex, Inc. ("Qwest Dex") represents an extraordinary transaction transferring a major segment of Qwest's business, the directory publishing business, that has historically been recognized above the line in establishing telephone services rates, to an unrelated third party buyer.

Several internal reorganizations of the Qwest directory business have occurred in the past. What has become known as the "1988 Settlement Agreement" between Staff and Qwest resulted from the initial reorganization back in 1983. In recognition of the integral relationship between the telephone and directory businesses, that agreement provided for imputation of a fixed $43 million in revenues in the determination of intrastate operating income for purposes of determining Qwest's revenue requirement in any rate case filed with the Arizona Corporation Commission ("Commission").

The proposed Settlement Agreement addresses the financial aspects of the proposed transfer of Dex to a third party buyer. The proposed Stipulation between Staff and Qwest recognizes the extraordinary nature of this transaction, and that a sale to an unrelated third party was most likely not contemplated by the 1988 Settlement Agreement. Consequently the proposed Stipulation contains a significant upward adjustment to the revenue imputation credit from $43 million to $72 million for a period of 15 years, which is an increase of 67%.

While the proposed Settlement is different from the settlement agreements reached in Washington and Utah, the two other Qwest States with jurisdiction over this matter, it reflects the unique regulatory and litigation history associated with directory revenue imputation in Arizona, and Staff's belief that a larger revenue credit would have longer-term benefits for consumers than a one-time bill credit.

The objections of both the Residential Utility Consumer Office ("RUCO") and the Department of Defense and all Other Federal Agencies ("DOD") should not obscure the benefits of the Stipulation and should not prevent approval of it by the Commission. Their objections do not give sufficient weight to the risks presented. Further, the alternatives offered by RUCO and DOD produce distant and uncertain benefits.

Without question, but for the dire financial circumstances of Qwest, Staff very well might not be recommending approval of the transfer of DEX to an unrelated third-party at all. As Staff witness Brosch opined, "[t]he current liquidity problems faced by QCI are mitigated in the short term by using the Dex sale cash proceeds to satisfy creditors. However, as noted elsewhere in my testimony, the substantial annual Dex income and free cash flows will no longer be available to QCI to meet ongoing capital requirements in the longer term."[1] Nonetheless, since Staff believes that the sale of Dex may allow the Company to survive its financial crisis, Staff believes that the transfer should be approved and that the new Settlement Agreement appropriately balances the unique circumstances of the Company at this time while ensuring that a fair portion of the economic value of the Dex business is attributed to customers.

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[1] Brosch Direct Test., Ex. S-1, at 18.

II. BACKGROUND

A. Transaction Overview

On September 3, 2002, QCI, QSC and Qwest filed a notice of sale of the directory publishing assets in Arizona held by Dex to an unrelated third party buyer. The sale is comprised of two principal purchase agreements: the Dexter agreement and the Rodney agreement, involves the sale of the entire business of Dex in two stages which will close at different times. The first stage or agreement is known as the Dexter stage, includes all Dex operations in Colorado, Iowa, Minnesota, Nebraska, New Mexico, North Dakota, South Dakota and El Paso, Texas and has already closed. The second stage or agreement is known as Rodney, and includes all of Dex operations in Arizona, Idaho, Montana, Oregon, Utah, Washington and Wyoming.

The Buyer is Dex Holdings, L.L.C., a Delaware limited liability company, that has been newly formed by Carlyle Group ("Carlyle") and Welsh, Carson, Anderson & Stowe to purchase the Dex publishing business.

The agreed-to purchase price for the entire Dex publishing business is $7.05 billion, subject to adjustment for working capital and final audited Dexter and Rodney financial statements. Of the total amount, $2.75 billion will be allocated to Dexter and $4.3 billion will be allocated to Rodney.

The Dexter transaction closed on December 15, 2002. The Rodney transaction is scheduled to close on December 15, 2003.

In addition to the purchase agreements governing these transactions, the parties have executed the following ancillary agreements in connection with the purchase: a Separation Agreement[2], Transition Services Agreement[3], Professional Services Agreement[4], Joint Management Agreement[5], Publishing Agreement,[6] Directory License Agreement[7], Non-Directory License Agreement[8], Public Pay Stations Agreement,[9] IP Contribution Agreement [10]and a Trademark License Agreement[11].

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[2] Agreements for sharing of assets, systems and facilities between Dexter and Rodney following the Dexter closing.
[3] Agreement whereby QC1 and its subsidiaries will provide back-office and other support services to Dexter following the first closing for a period of up to 18 months.
[4] Agreement whereby Dexter will provide necessary centralized service that Rodney will require following the first closing as a result by the transfer of certain personnel to Dexter at the first closing.
[5] Agreement whereby Rodney and Dexter will each employ key senior management team executives during the transition period.
[6] Agreement designating the Buyer as QCs exclusive official publisher in the region.

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

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

Qwest states that its provision of telecommunications services in Arizona will not be affected by this transaction in any way.

B. Procedural Overview

QCI, QSC and Qwest filed their application and notice of sale and request for waiver on September 3, 2002 pursuant to A.A.C. R14-2-801 through A.A.C. R14-2-806. (the "Affiliated Interest Rules"). In letters dated September 16, 2002 and October 25, 2002, Qwest waived and/or extended the deadlines set forth in A.A.C. R14-2-806(C)and R14-2-803(B). Staff filed a request for a procedural order on December 4, 2002.

The Commission's Hearing Division issued a procedural order on December 24, 2002, which provided for the following procedural schedule to govern this case:

Qwest/Dex Holdings Direct Testimony	January 28, 2003
Staff/Intervenor Rebuttal Testimony	March 4, 2003
Qwest/Dex Holdings Surrebuttal Testimony	April 1, 2003

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[7] Agreement granting buyer for term of Purchase Agreement a restricted license to use the directory publisher and directory delivery lists sole purposes of publishing and delivering directories to QC's 14-state region.

[8] Agreement giving Buyers a restricted license to use the subscribers list information in its direct marketing activities for a term of 5 years.

[9] Agreement whereby Buyer will place directories in Qwest's public pay stations in region for the term of the publishing agreement.

[10] Agreement assigning or licensing the intellectual property used in the yellow pages business to the Buyer.

[11] Agreement granting Buyer a license to use the "Qwest Dex" trademark for 5 years to sell directory products and direct marketing products within Qwest.

Staff/Intervenor Rejoinder	April 22, 2003
Pre-hearing Conference	April 29, 2003
Hearing Commences	May 6, 2003

Applications to Intervene were filed by the RUCO, MCI WorldCom ("WCom") and the DOD.

Qwest filed the testimony of its witnesses, Maureen Arnold, George Burnett, Peter Cummings and Brian Johnson on January 28, 2003. Testimony was also filed by Dex Holdings witness William Kennard on January 28, 2003. The DOD filed rebuttal testimony of Richard Lee on March 4, 2003. RUCO filed rebuttal testimony of Dr. Ben Johnson on March 19, 2003. Finally, Staff, having requested and been granted an extension of time, filed its rebuttal testimony of Michael L. Brosch on March 28, 2003.

On March 28, 2003, Staff also gave parties and Administrative Law Judge ("ALJ") Rodda notice that it had reached a settlement in principal with Qwest in this case.

On April 18, 2003, Staff and Qwest filed a Joint Notice of Filing Settlement Agreement and Motion for Procedural Order. Qwest also filed the Surrebuttal Testimony of Maureen Arnold, Philip Grate, Peter C. Cummings and Anne Koehler-Christensen on April 18, 2003.

The Commission issued a procedural order on April 25, 2003 setting a new schedule in light of the Stipulation filed by Qwest and Staff. On April 28, 2003, Qwest filed the testimony of Maureen Arnold in support of the Stipulation. On this same date, Staff filed the testimony of Michael L. Brosch in support of the Stipulation. On April 28, 2003, a statement in support of the Stipulation was filed by Dex Holdings. The DOD filed rejoinder testimony on May 9, 2003 opposing the Stipulation. On May 9, 2003, RUCO also filed rejoinder testimony of Ben Johnson opposing the Stipulation.

A hearing was held on this matter on May 16, 2003, and May 27-28, 2003. Following is Staff's Post-Hearing Brief in support of the proposed Stipulation.

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III. ARGUMENT

A. The Proposed Stipulation is in the Public Interest

1. <u>The Stipulation Resolves Contentious Jurisdictional Issues and Adopts Staff's Position that the 1988 Settlement Agreement Must be Replaced with a New Agreement Reflective of the Extraordinary Nature of the Transaction</u>.

In its Notice and Application, Qwest requested that the Commission declare that: (1) this transaction falls within the scope of the waiver granted in Commission Decision No. 58087; or (2) the sale of Directory Assets is not subject to Commission regulation based on a 1988 Mountain Bell Settlement Agreement. Alternatively, Qwest requested in the Notice, that the Commission waive compliance, in part with the Affiliated Interest Rules or approve the Sale of Directory Assets.

It is Staff's position, on the other hand, that the Commission has jurisdiction over the transfer of these assets under the Commission's Affiliated Interest Rules. Staff also believes that the Commission may have jurisdiction over the transfer pursuant to A.R.S. §40-285 to the extent that Dex holds assets that are used and useful in the provision of utility service.

That Dex's assets are used and useful in the provision of utility service and that ratepayers retain a valid claim upon Dex is underscored by the testimony of Staff witness Brosch. <u>See</u> Brosch Direct Test., Ex S-1 at 30-33. The directory business of Qwest in Arizona has consistently been operated in coordination with the regulated telephone operations under common ownership, so as to capture the tremendous economic benefits of publishing directories in conjunction with (and as an offset to the costs of) providing telephone services. Mr. Brosch also explains that the Dex directory operations are integrally linked to the provision of local phone service, such that directory publishing income is rightfully credited or imputed in to the telephone company's revenue requirements. <u>Id</u>. at 31-32. The 1988 Settlement Agreement provided for continued Commission oversight over the books and records of Dex and established a presumptive imputation amount of $43 million in revenues to be used in determining the intrastate revenue requirement associated with any Company rate case filing in the future, all in recognition of the integral linkage between the two businesses.

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Further, as Mr. Brosch points out in his direct testimony, it is Staff's position that the 1988 Settlement Agreement cannot legitimately be used to argue that it applies to such an extraordinary transaction as the instant sale to an unrelated third party buyer.

> The Mountain Bell directory publishing assets in Arizona that were transferred as of January 1, 1984 included \$56.3 million in cash and \$8.3 million of fixed assets including a building, PBX, motor vehicles, furniture and computers, less \$2 million in accounts payable assumed by the affiliate. The cash balance transferred to the publishing affiliate 20 years ago cannot be sourced into the present transaction, because cash assets of Dex are retained by the seller. Thus it is unlikely that any of the tangible directory assets that were transferred out of Mountain Bell in late 1983 are significant to the Dex business being sold 20 years later. In addition, the more important elements of value now being sold are the intangible assets associated with the ILEC official publishing rights, the goodwill and going concern value of the business and its customer relationships, the long-term Noncompetition Agreement and the Qwest Dex trade names and marks. There was no sale or permanent transfer of intangible assets associated with the right to serve as official publisher. The publishing agreements commencing in 1984 conveyed a right to use these intangible assets during the term of the Agreements, in effect renting them as part of the official publisher status that was granted to USWD.

(Brosch Direct Test., Ex. S-1 at 28-29).

In summary, it is Staff's position 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 an unaffiliated buyer. (Brosch Supp. Test., Ex. S-2 at 2). However, even if the 1988 Settlement Agreement applies to this extraordinary transaction, then given the gain at issue, the value of fees and services reflected by this transaction, would certainly be far greater than the \$43 million reflected in the current agreement and consequently subject to significant upward adjustment.

Moreover, Qwest also argued that the limited waiver granted by the Commission in Decision No. 58087 divested the Commission of jurisdiction over the instant transaction. It is Staff's position that Qwest does not meet the conditions for limited waiver of the Affiliated Interest Rules in this case. In Decision No. 58087, the Commission determined that QC, its parent and affiliates are only required to file a notice of intent to organize or reorganize when organization or reorganization is likely to: (1) result in increased capital costs to QC; (2) result in additional costs allocated to the Arizona jurisdiction; or (3) result in a reduction of QC's net operating income. Qwest has not demonstrated that the reorganization will not ultimately impact capital costs to Qwest or ultimately result in a reduction of Qwest's net operating income.

In fact, Mr. Brosch discusses several new risks and issues in this regard that are presented by the sale of Dex to a third party buyer. The liquidation of the directory business terminates the 1988 Settlement Agreement creating uncertainty about how directory imputation is to be quantified or adjusted in the future. (Brosch Direct Test., Ex. S-1 at 39-40). The sale of the Dex income stream also substantially reduces the long-term ability of the Qwest consolidated businesses to generate cash flow from operations needed to service debt and attract capital on reasonable terms. Id. at 39. The sale of Dex will likely increase corporate shared costs to be borne by Qwest. Id. at 40. These new risks and costs arising from the sale of Dex clearly demonstrate that Qwest could not meet the conditions for waiver in this case.

The Stipulation resolves all of these contentious jurisdictional issues, and would obviate the need for continued litigation on them. In Staff's view the Stipulation reflects Staff's position that the 1988 Settlement must be replaced with a new agreement which recognizes the extraordinary nature of this transaction.

2. The Proposed Settlement Results in Approval of a Transaction that Qwest Claims is Critical to Qwest's Ability to Avoid Bankruptcy.

The proposed Settlement Agreement recognizes that the sale of Dex is an extraordinary transaction, and that QCI would probably not be selling Dex if not for the poor financial performance of its non-regulated businesses. (Brosch Direct Test., Ex. S-3, at 14). As Qwest Witness Cummings stated: "[t]he sale of Dex (both phases) remains critical to Qwest's ability to avoid bankruptcy in the short and intermediate term."

Qwest witnesses Johnson and Cummings describe in some detail the deterioration in Qwest's consolidated financial performance, credit rating downgrades to junk status, accounting investigations and Qwest's resulting liquidity crisis. As Staff witness Brosch pointed out in his testimony, while it may have been possible for Qwest to sell assets or business segments other than Dex, issue new securities at extremely high cost or reorganize the business through a merger, the sale of Dex was an attractive option for several reasons.

> Dex is an attractive business segment to sell because of its enviable market position, robust cash flows and financial strength and will therefore yield cash proceeds upon sale that are large enough to measurably improve Qwest's financial condition by reducing debt leverage. Notably, the Dex sale is larger, but similar to other directory sale transactions recently announced by Sprint, McLeod USA and Bell Canada to improve liquidity and access to capital markets.

(Brosch Direct Test., Ex. S-3 at 41).

The current liquidity problems faced by QCI are mitigated in the short term by using the Dex sale cash proceeds to satisfy creditors. While there is little doubt that QCI will sorely miss the income and cash flow produced by Dex after the sale, the Company had little choice but to monetize this asset to meet the demands of its creditors.

Because the proposed Dex sale is critical to the efforts of Qwest to improve liquidity and maintain access to capital markets on reasonable terms, Staff believes that the Settlement achieves benefit for the Company and Arizona consumers

3. <u>The Proposed Settlement Results In Long-Term Benefits to Consumers By Significantly Increasing the Revenue Credit For the Next 15 Years.</u>

The Stipulation between Qwest and Staff increases the annual imputed directory revenues from $43 million to $72 million. The Stipulation provides that for a period of 15 years, the amount of annual directory revenues imputed to Qwest and included in determining Qwest's test year operating income will be $72 million. The 15 year period is to begin on the date Qwest submits its first Price Cap Plan review filing. In the event of any Qwest rate case, earnings or Price Cap review or other rate proceeding commenced between July 1, 2003 and July 2018, the amount of annual directory revenues imputed to Qwest in determining its test year operating income would be $72 million. The Stipulation further provides that any Basket Price Cap adjustments, Index adjustments, and/or individual rate adjustments resulting from the Stipulation and review, modification or renewal of the Price Cap Plan are subject to modification and approval by the Commission. Under the Stipulation, Qwest is also required to include the directory revenue imputation value within all reporting to the Commission of Qwest's Arizona intrastate earnings or rate of return during this period.

As Staff witness Brosch noted in his pre-filed direct testimony in this case, the revenue credit provided for in the 1988 Settlement Agreement has been a persistently bad deal for ratepayers:

> The Settlement Agreement failed to provide for any growth in directory publishing revenues or profits, effectively leaving all of such growth for the sole benefit of shareholders. My testimony in the 1993 USWC rate case supported an increase in imputation from $43 million to about $60 million and the Commission's Decision No. 58927 approved this increased imputation. However, as noted on page 9 of Ms. Arnold's testimony, USWC successfully appealed the Commission's Order based upon the 1988 Settlement Agreement requirement that imputation was limited to 'fees and the value of services received by USWC from USWD under publishing agreements with USWD. The Commission was forced to increase rates to reflect reduced imputation back to the $43 million level, even though it had found higher imputation to be more reasonable.

(Brosch Direct Test., Ex.-S-1 at 25-26).

Staff believes that a revenue credit provides a longer-term benefit for ratepayers than a one-time bill credit. Since the 1988 Settlement Agreement was woefully inadequate in terms of the revenue credit provided to Arizona ratepayers, a primary objective of Staff was to address this deficiency for the long-term benefit of ratepayers. Staff was interested in negotiating increased annual revenue credits to improve upon the understatement of directory revenues reflected in the ratemaking process. Staff witness Brosch recognized that the importance of securing a reasonable attribution of the gain to Arizona customers in the form of increased revenue credits:

> .....[T]he interests of ratepayers in the Dex business are not subordinate to the interests of shareholders in preserving the gain and cash proceeds for corporate purposes. A reasonable attribution of the gain to Arizona customers is necessary to secure increased imputation levels (or an economic substitute for such imputation) and ensure that the sale of Dex is consistent with the public interest. It remains possible that Qwest will not survive its liquidity crisis even with the sale of Dex. If a Qwest bankruptcy eventually occurs, there may then be less of an opportunity to be sure that customers' interest in the Dex business are safeguarded.

Id. at 42.

The sale of Dex yields a very large gain on sale, a good portion of which Staff believes Arizona ratepayers are entitled. The new Settlement Agreement is a compromise that uses most of the Arizona portion of the gain on sale to benefit customers, rather than shareholders as originally proposed by Qwest. Use of a one-time bill credit would have meant lower annual revenue credits which would not have be as advantageous to ratepayers in the future.

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4. <u>The Proposed Settlement Strikes an Appropriate Balance Given the Various Litigation Risks Presented.</u>

As Staff witness Brosch pointed out, the following substantive provisions of the Settlement Agreement between Staff and Qwest provide significant increased customer benefits through the resolution of many contentious issues surrounding the transfer:

- 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.

(Brosch Supp. Test., Ex. S-2 at 1-2).

As Staff witness Brosch noted in his Supplemental Testimony, the 1988 Settlement Agreement has been very 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. <u>Id.</u> at 2-3.

Besides settling the imputation issue, the Settlement Agreement resolves other important legal issues which otherwise presented considerable risk and accordingly resulted in adjustment of Staff's original position. These include, <u>inter alia</u>, Qwest's jurisdictional arguments, what portion of the gain ratepayers should receive, and Qwest's carve-out for secondary directories and non-Qwest listings.

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B. DOD and RUCO's Objections Should Not Prevent Approval of the Settlement

1. <u>DOD's Objections to the Proposed Settlement Do Not Give Appropriate Weight to the Litigation Risks Presented</u>

DOD witness Richard B. Lee argues that the Stipulation is not in the public interest because he does not believe that it provides adequate compensation to local ratepayers for the sale of Dex. (Lee Rejoinder Test., Ex. DOD-3 at 2). The reasons given by Mr. Lee, however, do not support rejection of the Stipulation between Staff and Qwest.

First, Mr. Lee argues that from a ratepayer's perspective, he does not believe the Settlement Agreement provides an appropriate balancing of litigation risk versus settlement benefits. <u>Id</u>. at 3. However, when cross-examined on this point, Mr. Lee noted that he is allocating the entire gain as a subsidy to ratepayers, even though there were several litigation risks that should have been considered. (Tr. at 50-54).

Second, Mr. Lee compares the percent allocation of gain under each of the various proposals, including the Settlement Agreement, concluding that the benefit under the Stipulation is not a reasonable compromise. (Lee Rejoinder Test., Ex. DOD-3 at 4). Alternatively Mr. Lee would have had Qwest and Staff "split the difference between their positions". <u>See</u> <u>id.</u> at 5. As already discussed, however, Mr. Lee conceded that litigation risks should be considered, yet any "split the difference" approach is a crude methodology to consider the nuances of the many issues raised in this proceeding.

Third, Mr. Lee is concerned that local service ratepayers may never actually see a benefit from the sale of Dex without an immediate bill credit. <u>Id.</u> However, as already explained, one of Staff's primary objectives was to address the 1988 Settlement Agreement's seriously deficient imputation amount. The increased imputation amounts negotiated by Qwest and Staff will be immediately considered in the review of Qwest's price cap plan in 2003. In contrast, any upfront bill credit to customers suggested by the DOD would have to be offset from any imputation amount agreed to, diluting the more permanent benefits achieved in the Stipulation. Staff believed that a higher imputation amount for a period of 15 years would be of overall greater benefit to Arizona consumers now and in future years.

In summary, the Commission should reject DOD's analysis since it attributes all of the Arizona share of the Dex gain on sale with no consideration of litigation risks associated with the 1988 Settlement Agreement, Arizona Court of Appeals determinations related to that Settlement Agreement or prior ACC decisions regarding sharing of the gain on sale.

2. RUCO's Objections to the Settlement are not Supportable.

RUCO witness Ben Johnson also objects to the Stipulation for several reasons. First Mr. Johnson claims that the Stipulation results in a severe mismatch between the duration of imputation credits (15 years) and the duration of the services that will be provided by Qwest under the new Publishing Agreement (up to 50 years). (Johnson Rejoinder Test., Ex. RUCO-6 at 2-3). Staff, like DOD, believes that a 15 year period is appropriate, and that one starts to introduce significant uncertainty and diminished tangible value to customers when using any longer period. Assuming any increase in competition or continuation of price cap regulation, revenue credits beyond 15 years would create no value to customers because traditional regulation is unlikely to be practiced. At the same time, it would unreasonably reduce the amounts available in each early year to produce distant and highly uncertain benefits.

Mr. Johnson attempts to show the Staff/Qwest Settlement to be inadequate by calculating a hypothetical and growing imputation amount using access line growth statistics, along with an inflation factor. Id. at 3-4. RUCO's assumption of ever-increasing imputation due to access line growth is not supported with the history of imputation in Arizona and past rulings of this Commission, where amounts imputed in setting rates have remained at $43 million since divestiture. The 1988 Settlement Agreement does not provide for adjustment of imputation based upon access lines or inflation and the Commission has never employed such an approach. The status quo is $43 million from the 1988 Settlement Agreement, the amount embedded in current rates that has been upheld by the Arizona Court of Appeals. Most importantly, there has been no showing by RUCO that changes in access lines or changes in inflation have anything to do with directory advertising revenues or profits in Arizona.

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C. The Alternatives Offered by the DOD and RUCO Result in Distant and Uncertain Benefits.

1. RUCO's Proposal

RUCO witness Johnson's recommendations are contained on Schedule 1 and page 16 of his Rejoinder Testimony and provide for imputation to occur for a period of 45 years. Unlike DOD's witness, RUCO's witness Johnson does not support up-front revenue credits. Id. at 2-3. In addition, the $43 million imputation from the 1988 Settlement Agreement would be arbitrarily adjusted upward during this extended period based alternatively upon line growth, or line growth and inflation, even though such escalation factors were not part of the 1988 Settlement. Id. at 3.

While certainly this a more favorable financial package than that agreed to by that Staff, as already discussed, it has no basis. There has been no showing that changes in access lines or inflation have anything to do with directory advertising revenues or profits in Arizona. Furthermore, the alleged benefits to be received are speculative at best. As already noted, under price cap regulation and with changes in regulation generally, it may be that RUCO's proposal would actually be of more limited value to consumers, than it first appears. If line growth alone is considered, for the 15 years agreed to by Staff, even though such an approach is at odds with ACC imputation methods and the 1988 Settlement Agreement, it would mean the difference between $83.9 million and Staff's proposal of $72 million that Qwest has already agreed upon.

2. DOD's Proposal

In addition to upfront bill credits for 10 percent of the Arizona share of the gain, DOD proposed regulatory liability accounting with amortization over 15 years, producing total customer benefits ranging from $193.2 million in year one down to $65.9 million in nominal dollars by year 15 (Tr. 53.; Ex. DOD-4). While certainly this would be a great outcome for consumers in the early years, DOD's own witness acknowledged that he attributed all of the Arizona share of the Dex gain on sale with no consideration of litigation risks associated with the 1988 Settlement Agreement or prior ACC decisions regarding gain on sale.

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Further, DOD's proposals are extreme in their impact upon Qwest, at a time when the Company is attempting to improve its liquidity and access to capital markets. Mr. Lee's Rejoinder Exhibit RBL-5 indicates his proposed front-loaded customer credits total $970 million in the first five years (Total Credit amounts, years 0 through 5). In contrast to either the existing $43 million annual imputation embedded in Arizona rates or the negotiated $72 million per year, DOD's proposal is not reflective of any balancing of the interests of ratepayers and shareholders and may undermine the Company's ability to remain solvent. Under the Stipulation with Staff, Qwest has agreed to take the increased $72 million revenue credit amount into consideration at each price cap review, while using the cash proceeds from the sale of Dex to improve its financial condition and avoid bankruptcy. This approach reflects an appropriate balancing of the near-term and long-term public interest in protecting consumers while assuring a financially viable telephone utility.

D. The Stipulation Reflects a Careful Balancing of Litigation Risks Unique to Arizona and As a Result, Falls Between the Other Two Settlements Reached in This Matter In Terms of Nominal Value Obtained.

1. The Utah Settlement

In Utah, one-time bill credits were agreed upon with no change in the underlying imputation of $30.1 million per year, because price cap regulation is mandated by statute in Utah. Under Utah price cap regulation, no rate cases can occur in the future and ratepayers cannot realize any Dex sale benefits in the form of increased annual imputation revenue credits. The one-time bill credits were negotiated in Utah as a compromise to attribute some benefits to ratepayers, albeit only on a one-time basis.

In entering into the Stipulation with Qwest, Staff was primarily concerned with the serious understatement of annual revenue credits under the 1988 Settlement. Therefore, Staff's focus was upon increasing the $43 million revenue credit with a firm, unconditional $72 million imputation amount, rather than securing one-time benefits that will do nothing to reduce ongoing annual revenue requirement.

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2. The Washington Settlement

The Washington Stipulation is based upon specific factual information and regulatory practices in that State that differ from Arizona's treatment of directory revenues. Washington, has for many years, practiced "full" imputation, as if the Dex business remained a part of the regulated telephone company. In each rate case proceeding in Washington, the Commission evaluates the achieved earnings of the publishing affiliate and returns all excessive directory earnings to telephone ratepayers through an imputation adjustment. This has produced consistently growing imputation amounts that exceeded $85 million in the most recent 1997 Washington rate case. It is reasonable to expect that directory imputation amounts would have continued to grow in future rate cases before the WUTC under the methods used in that State that have been affirmed by the Washington Supreme Court. U S WEST Communications, Inc. v. Util. and Transp. Comm., 949 P.2d 1337 (1997).

In contrast, Arizona imputation has been limited by the 1988 Settlement Agreement that presumes annual imputation of only $43 million to be reasonable (absent a showing that the value of fees and services to Qwest Corporation is greater). The earnings-based imputation approach (as used in Washington) was recommended by Staff witness Brosch and ordered by the Arizona Corporation Commission in a 1993 rate case, only to later be overturned by the Court of Appeals as inconsistent with the 1988 Settlement Agreement.

Because of the unique history of litigation in Arizona, the 1988 Settlement Agreement and the Price Cap Plan Review, Staff believes that the Arizona Stipulation compares favorably to both Utah and Washington. The nominal values in the Arizona Stipulation are lower than in Washington, but higher than in Utah because of the unique regulatory histories and litigation risks associated with directory imputation in each state. However, if one compares the incremental value to ratepayers in the Arizona Stipulation, relative to the 1988 Settlement Agreement, to the ratepayer benefits achieved incrementally in Washington and Utah, the Arizona Stipulation added more value to ratepayers than was achieved in the other two states (Ex. Q-11).[12] The Stipulation resolves many contentious issues raised by Qwest and the other parties regarding ACC jurisdiction over the transaction, gain on sale

[12] The above discussion is consistent with Staff witness Brosch's testimony at the hearing in response to questions posed by Commissioner Mundell in a letter docketed on May 23, 2003, regarding the differences between the settlements reached on this matter in the various states.

allocations, income taxes, gain on sale sharing policies, the 1988 Settlement Agreement and ratepayer impacts, all in a manner distinctly and immediately favorable to Arizona ratepayers within the price cap review proceeding to occur later this year.

IV. CONCLUSION

The Stipulation between Qwest and Staff reflects an appropriate balance between ratepayer and shareholder interests in this case and should be approved by the Commission.

RESPECTFULLY SUBMITTED this 24th day of June, 2003.

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