BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Joint Application of VERIZON COMMUNICATIONS INC. AND FRONTIER COMMUNICATIONS CORP. For an Order Declining to Assert Jurisdiction Over, or, in the Alternative Approving the Indirect Transfer of Control of Verizon Northwest Inc.	DOCKET NO. UT-090842

POST-HEARING BRIEF OF PUBLIC COUNSEL

FEBRUARY 26, 2010

REDACTED VERSION

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Statutes

Rules

UTC Cases

Other Administrative Cases

Other Authorities

I. INTRODUCTION AND SUMMARY OF POSITION

1. The record in this case demonstrates that the proposed sale of Verizon's Washington wireline operations to Frontier is not in the public interest and must be denied. Even with the conditions included in the various settlements, the proposed sale would substantially harm Washington ratepayers.

2. Instead of providing evidentiary support for their positions, Verizon and Frontier have relied on unsupported assertions and a continuing mantra of "just trust us, we've done this before." Thus, the record lacks adequate information with which the transaction can be meaningfully evaluated. The financial model, upon which the purchase price and Frontier's financial projections are based, cannot be tested because, despite requests for a functioning model, Frontier purposefully provided parties only a non-functioning, locked-down version. Moreover, Frontier has not created a capital budget for Washington State. Frontier has also not secured financing for the $3.3 billion debt it must take on to complete the transaction, so the cost of that debt is unknown. Finally, neither Frontier nor its financial advisors have vetted the allocations that Verizon used to value sale, even though many of the allocations are boldly optimistic.

3. What the record *does* show is that Frontier is a financially weak company that needs this transaction to bolster its declining financials. Frontier has a junk-bond rating and has been experiencing steadily-falling revenues. The record also indicates the very real likelihood that Verizon has over-valued the transaction. Indeed, Verizon did just that in three recent sales which have *all* ultimately resulted in bankruptcy of the buyer. Despite this, Frontier did no physical inspections of plant in Washington, instead relying entirely on "generic data" during the due

ATTORNEY GENERAL OF WASHINGTON
Public Counsel
800 5th Ave., Suite 2000
Seattle, WA 98104-3188

diligence phase.[1] Also, the record shows that Frontier's revenue projections post-sale are most likely overstated due to overly optimistic projections related to line loss, capital expenditures, and synergy savings. Finally, Verizon will walk away from the sale $8.6 billion richer, but will not have to stand behind the functionality of the replicated operating system or the condition of essential plant. Verizon has assured this result, including a provision in the Merger Agreement that attempts to circumvent regulatory oversight and would pass on the costs of any regulatory requirements to Frontier.

4. It is also clear from the record that Staff's final-hour change of position—from recommending rejection to entering a settlement with minimal conditions—is unsupported. Troublingly, Staff did little of its own analysis and could not provide evidentiary support for many of its final positions. In the end, Staff supported a settlement that offers no financial safeguards, no assurance that ratepayers will benefit from potential synergies, no protection from service quality deterioration. The settlement also increases the likelihood of higher rates and more restrictive usage terms, and includes only inadequate commitments for broadband deployment.

5. This Commission should not be swayed by fear that ratepayers will be worse-off if Verizon is "forced" to continue providing wireline service in the state. As a regulated incumbent carrier, Verizon has a legal duty to provide service commensurate with this Commission's standards. Moreover, Verizon has gone to great lengths in this proceeding to show that it has, in fact, provided satisfactory service and invested substantial sums in Washington. These assertions contradict the Joint Applicants' assertions that the Company does not want to be here.

[1] McCarthy, TR. 350:14-15.

Finally, regardless of Verizon's strategic goals, it will remain financially able to provide wireline service, whereas Frontier faces the very real risk of financial failure.

For these myriad reasons, Public Counsel must respectfully urge this Commission to reject the proposed sale and settlements.

II. BACKGROUND OF THE SALE AND PROCEEDING

A. The Joint Applicants – Verizon.

6. Verizon Communications Inc. (Verizon) has positioned itself as one of the two largest telecommunications providers in the United States, growing through a series of mergers to now serve 35.2 million wirelines in 25 states.[2] Verizon is a diversified and financially strong company, with an investment-grade, single-A bond rating.[3] Additionally, Verizon's national policy has been heavily focused on deploying FiOS, which provides fiber-to-the home (FTTH). In recent years, Verizon has made substantial investments in Washington associated with its FiOS service. As a result, many Washington consumers have benefited from the availability of state-of-the-art high-speed data services, as well as having Verizon as an alternative facilities-based supplier of video services.

B. The Joint Applicants – Frontier.

7. Like Verizon, Frontier Communications Corporation (Frontier) is also the product of various mergers and acquisitions, and has grown to serve 2.2 million access lines in 24 states.[4] Frontier's bond rating is below investment grade.[5] Frontier's historical financial results show that its financial condition is deteriorating and that its business model has been unable to slow

---

[2] Exh. No. TRR-1HCT, p. 6:9-10 (Roycroft Direct).
[3] Investment-grade bonds carry lower investment risk and thus offer lower yields to investors and a lower cost of capital to ratepayers.
[4] Exh. No. TRR-1HCT, p. 7:16-19 (Roycroft Direct).
[5] Exh. No. SGH-1HCT, p. 21:12-13 (Hill Direct).

that deterioration. It is notable that this deterioration continued even during the period in which Frontier made a large acquisition of additional telephone access lines (from Commonwealth Telephone). Despite that boost in access lines and cash flow, Frontier's finances have continued to falter.[6]

8. Frontier's business model is based on deploying "first generation" DSL,[7] for which the Company plans expanded availability in Washington.[8] Frontier has stated it plans to meet the FiOS commitments Verizon has made, but does not have plans to expand this service beyond those commitments.[9]

C. The Proposed Sale.

9. The proposed sale would transfer over 4.8 million access lines in numerous states from Verizon to Frontier, resulting in Frontier tripling in size, from 2.2 million to 7 million access lines.[10] In Washington, Frontier would obtain approximately 578,000 access lines from Verizon, which would make up 8.2 percent of the post-sale Frontier.[11] Verizon proposes to retain some operations in Washington, including large business customers and wireless service.[12]

10. The Merger Agreement states that the sale has an overall value of $8.6 billion. Frontier must provide $3.3 billion of the value in cash.[13] In order to satisfy this cash requirement, Frontier must secure debt financing for the full $3.3 billion. However, Frontier has not provided any certainty or specifics regarding the syndication of the actual credit facility or the cost of

---

[6] Hill, TR. 423:14 – 426:8.
[7] Roycroft, TR. 448:4-5.
[8] Exh. No. DM-1T, pp. 17:16-18:17.
[9] McCarthy, TR. 497:16-21.
[10] Exh. No. TRR-1HCT, p. 8:17-19 (Roycroft Direct).
[11] McCallion, TR. 376:11-14.
[12] *Id.* at 532:24 – 533:22.
[13] Whitehouse, TR. 568:17-19.

servicing the debt.[14] What is known is that if and when Frontier goes to the market, the credit facility will be "shopped around" as a below-investment grade issue.[15] The balance of the value would consist of *up to* $5.25 billion in equity, provided by Frontier through a stock issuance of up to 750 million shares.[16] However, according to Frontier, if its stock price falls below $7.00 ($5.25 billion / 750 million shares) at the time of close, the overall value of the sale would likewise diminish.[17]

D. Summary of the Proceeding and Proposed Settlements.

11. Verizon and Frontier filed a Joint Application for approval of the proposed sale with this Commission on May 29, 2009, and direct testimony in support of the Application on July 6. In its direct testimony, both Public Counsel and Staff recommended that the Commission reject the sale, citing numerous risks and harms and expressing serious concerns regarding the lack of information and evidence provided by the Joint Applicants. On December 11, three days before the evidentiary hearing was scheduled to begin, Staff and the Joint Applicants informed the Commission that they had reached a settlement in principle. Public Counsel participated in the settlement discussions between the Joint Applicants and Staff, and ultimately determined that the proposed settlement conditions do not alleviate the numerous concerns previously expressed by Public Counsel and Staff.

12. The settlement with Staff was filed on December 24. Public Counsel undertook additional discovery regarding the Settlement and presented oral rebuttal evidence in response at the evidentiary hearing in this case, which commenced on February 2, 2010.

---

[14] *Id.* at 569-576.
[15] Whitehouse, TR. 572-576.
[16] Weinman, TR. 269:24 – 270:20.
[17] Frontier has stated that will not issue additional debt to make up any "equity shortfall." *See* McCarthy, TR. 270:14-20.

III. STANDARD FOR REVIEW AND APPROVAL

13. RCW 80.12.020 requires Commission approval of proposed sales or transfers of property. If a proposed sale is not consistent with the public interest, the Commission must deny the application.[18] Where two or more parties have reached settlement, the Commission considers whether the transaction is in the public interest "in light of the parties' [s]ettlement."[19]

14. The Commission applies a "no harm" standard to determine whether a proposed sale satisfies the public interest.[20] To meet this standard, the Joint Applicants must demonstrate the proposed sale causes no harm.[21] When analyzing the harms, the Commission considers risks of harm and potential harms that may arise.[22] If the potential harms to the public outweigh the benefits to the public, the Commission must deny the sale or condition the approval in a manner that ensures that no net harm results.[23]

/ /

/ / /

/ / / /

---

[18] WAC 480-143-170.

[19] *In the Matter of the Joint Application of Puget Holdings LLC and Puget Sound Energy, Inc., For an Order Authorizing Proposed Transaction*, Docket No. U-072375, Order No. 8 (Order Approving and Adopting Settlement Stipulation; Authorizing Transaction Subject to Conditions), ¶ 121 (hereinafter *PSE Sale*).

[20] *Joint Petition for Declaratory Order on Behalf of Verizon Communications, Inc., and MCI, Inc., Disclaiming Jurisdiction Over, or in the Alternative, a Joint Application, for Approval of Agreement and Plan of Merger*, Docket No. UT-050814, Order No. 7, ¶ 56 (hereinafter *Verizon-MCI*).

[21] *Id.* at ¶ 56-57.

[22] *See, e.g., Joint application of Embarq Corporation and CenturyTel, Inc., For Approval of Transfer of Control of United Telephone Company of the Northwest, d/b/a Embarq and Embarq Communications, Inc.*, Docket No. UT-082119, Final Order, ¶¶ 43 and 53 (describing the "question of *potential harm* to customers" as "central" to the Commission's consideration of the proposed sale and noting the proposed settlement agreement offset both the "harms *and potential harms*" of the merger) (hereinafter *CenturyTel*); *PSE Sale*, Order 08, ¶ 116 (describing the Commission's duty to "thoroughly analyze the transaction's details [and] the *risks of harm to the public interest*...."); and *Verizon-MCI* at ¶¶ 134-135 (expressing concern that the proposed sale "offer[ed] few benefits to Washington, but impos[ed] significant harms *or risks of harm*") (emphases added).

[23] *Verizon-MCI*, Order No. 7, ¶ 59.

15. The Commission considers several factors to evaluate the harms and benefits of a proposed sale and any pending settlements.[24] In the 2005 Verizon-MCI merger case, the Commission focused on the following six factors:

> (1) the effects on retail and wholesale competition;
> (2) the surviving company's "technical, *managerial and financial capability*";
> (3) the potential *effects on service quality,* "including the impact on investment in Washington and neglect and abandonment of facilities";
> (4) how *synergies are shared* between shareholders and customers;
> (5) the financial effects on "cost of capital, cost structure, and *access to financial markets*"; and,
> (6) the effects on "*rates*, terms, and conditions of service."[25]

16. In assessing whether a proposed transaction and any pending settlements will result in harm, the Commission's focus is on the difference between the status quo, *i.e.*, the status under the proposed seller, and what the status would be under the proposed buyer.[26] In this case, the Joint Applicants must show, among other things, that Frontier has at least comparable financial capability to Verizon and will have at least comparable access to financial markets, that Frontier will provide at least the same level of service as Verizon does currently, and that ratepayers will receive service with at least comparable rates, terms, and conditions. If the Joint Applicants do not provide sufficient evidence on these points, or there is evidence to the contrary, or if pending settlements do not adequately address these areas, the Commission must reject the proposed sale.

---

[24] *See PSE Sale,* Order No. 8, ¶ 271 (stating that the Commission applies the "evaluative criteria derived from . . . precedent cases . . . in order to determine whether the transaction, if approved, would harm the public interest and thus be contrary to law").

[25] *Verizon-MCI,* Order No. 7, ¶ 59 (emphasis added). In a recent article, the National Regulatory Research Institute (NRRI) enumerated three conditions that regulators should find are satisfied before wireline sales are approved (Exh. No. SGH-28, p. 15):

- Is it in the public interest for the regulator to relieve the incumbent of its public service obligation?
- Relative to the seller, is the buyer [] at least comparably qualified to take over that obligation?
- Are the specific terms of the transfer such that the transaction itself is consistent with the public interest?

[26] *See PSE Sale,* Order No. 8, ¶ 59.

IV. THE PROPOSED SALE IS NOT IN THE PUBLIC INTEREST

17. The Joint Applicants have failed to contradict the strong evidence that the proposed sale will result in significant harms. Furthermore, the conditions of the various settlement do not adequately protect against the risks and harms that would result from the proposed sale. Moreover, neither the alleged benefits identified by the Joint Applicants in the application, nor the alleged benefits of the settlements, outweigh the many identified harms.

A. Verizon's Recent Experience with Asset Divestitures Raise Numerous Concerns.

18. Despite the Joint Applicants' assurances that this sale is different from previous Verizon divestures, there are important similarities that have a bearing on this case.[27] Thus, this Commission should look past these assurances, examine the circumstances of prior sales, and be wary of the potential that similar harms could result here.[28]

19. A primary likeness between this proposed sale and Verizon's previous sales is that the transactions involve significant increases in the acquiring company's debt. In previous sales to the Carlyle Group in Hawaii and FairPoint in New England, the additional debt magnified the buyers' financial weaknesses which then contributed to the severity of service quality problems experienced by those companies, including service outages, billing system malfunctions, call center problems, and 911 system failures.[29] Moreover, the increased debt ultimately led to the bankruptcy of both Hawaiian Telcom and FairPoint.[30]

---

[27] *See* Exh. No. TRR-1HCT, p. 12:16-18 (Roycroft Direct).

[28] The National Regulatory Research Institute (NRRI) pointed out the importance of scrutinizing past Verizon divestitures (Exh. No. SGH-28, p. 24):

> In the pending proceedings on the Verizon-Frontier sale, the parties have emphasized that the transition will be handled differently from the FairPoint migration. Applicants made similar statements in the Verizon-FairPoint testimony concerning how their transition would differ from the earlier unsuccessful cutover after Verizon's sale of its wireline operations in Hawaii. Regulators should look past these assertions and probe for facts.

[29] Exh. No. TRR-1HCT, p. 9:13-15, n.12 (Roycroft Direct).

[30] *Id.* at p. 9:13-15, n.13.

20. There are also important technical and managerial comparisons between this proposed sale and previous Verizon divestitures. The Joint Applicants have attempted to differentiate the Hawaiian Telcom transaction by pointing to problems associated with new back-office systems that the Carlyle Group created to administer Hawaiian Telcom's operations.[31] While the Hawaiian Telcom experience may have been driven by problems with new back-office systems,[32] this transaction involves building similarly complex, new "replicated" systems.[33] As to the FairPoint transaction, Frontier asserts that it will not experience similar problems because it is an experienced, multi-state provider. However, FairPoint, too, was an experienced, multi-state provider, serving in 18 states before taking over Verizon's operations. Yet, FairPoint's "management experience did not suffice when it encountered a broad range of operational, service quality, and financial problems."[34]

B. The Inflated Purchase Price Does Not Accurately Reflect the Value of the Assets to be Transferred.

21. In order to determine if the proposed sale is in the public interest, the Commission must have adequate evidence that the purchase price reflects the actual value of the assets and operations being purchased.[35] A purchase price inflated beyond the actual economic value of the Verizon operations could further undermine Frontier's already weak financial standing, leaving the company financially unable to operate.[36] In this case, the evidence suggests that the sale is

---

[31] Exh. No. TM-1T, p. 24:16-19 (McCallion Direct).
[32] Exh. No. TRR-1HCT, p. 12:12-13 (Roycroft Direct).
[33] Roycroft, TR. 672:16 – 673:24; Exh. No. TRR-1HCT, p. 12:14-15 (Roycroft Direct). This sale also has many incentives for Frontier to expeditiously end its use of Verizon systems to reduce costs. *Id.*
[34] Exh. No. SGH-28, p. 20.
[35] The debt and equity costs associated with the acquisition of the SpinCo assets could significantly reduce Frontier's financial flexibility, particularly if operating cash flows are lower than the optimistic projections. *See* Exh. No. SGH-1HCT, pp. 29:10-13, and 32:15-17 (Hill Direct).
[36] Exh. No. SGH-28, p. 23.

overvalued. But given the Joint Applicants' failure to provide any information regarding the actual value of the properties and operations, just *how* overvalued the sale may be remains uncertain.

1. The purchase price is based on untested valuations.

22. The evidence on the record suggests that the proposed sale has not been accurately valued and that purchase price is thus too high. The valuations of the properties and operations to be transferred, *i.e.*, SpinCo, are predicated on the accounting assumptions of Verizon's management. Verizon's accounting allocations have been accepted by Frontier without any independent analysis. Meanwhile, Frontier's financial advisors have deemed the proposed sale to be "fair" based on unquestioned acceptance of projections based on *Verizon's* unvetted allocation assumptions. Furthermore, Frontier's advisors, who have not looked beyond the allocations provided by Verizon, have a lot to gain from the deal going forward—they have been promised substantial additional compensation at the time of closing.[37]

2. Verizon has a history of over-valuing assets it divests and had the ability to do so here.

23. The likelihood of an inflated purchase price is supported by the fact that Verizon has a history of savvy deal-making. In all three recent Verizon divestitures (FairPoint, Hawaiian Telcom, and Idearc), the assets transferred were ultimately worth far less than what Verizon received for them.[38] As the *Wall Street Journal* explained in August, 2009:

> Verizon Communications Inc. boss Ivan Seidenberg may be one of the best deal makers of his time, or one of the worst. Today, three of Verizon's most significant divestitures are either in bankruptcy or near

[37] Both Evercore and Citigroup will receive $14 or $15 million in additional compensation if the merger is finalized. While they do not disclose dollar amounts, Barclays and JP Morgan Chase indicate that a substantial portion of the compensation for their fairness opinion is contingent on completion of the merger. *See* Exh. No. SGH-1HCT, p. 31:13-20 (Hill Direct).

[38] *Id.* at pp. 31:24-32:1.

> it. . . . In all, these companies have lost upward of $13 billion in value and counting. This should make Mr. Seidenberg a hero to Verizon investors. Not only did he bail out of the assets at the right moment, he *extracted prices that literally sucked the life out of the buyers.*[39]

Even without this reputation, it can be assumed that a corporation like Verizon (or any other seller) would seek the maximum profit it could gain from a sale of its assets. As Public Counsel witness, Stephen Hill, stated at hearing:

> Of course, any company, anybody that's selling a house or a car or anything is going to try to get the top dollar for that sale. And if you can within reasonable bounds affect the allocation process in your favor, you will do so.[40]

24. The evidence suggests that Verizon had the ability to overvalue this sale as well.[41] Verizon had considerable leverage in the development of the sale price, which went unvetted by Frontier and its financial advisors. Although Verizon fiercely denied any implication that itmight have acted unethically, it has offered no evidence to support its position.[42] At hearing, Verizon witness, Steven Smith, defended the SpinCo carve-out methods by stating the, as a part of its standard business practices, Verizon complied with required accounting and regulatory measures.[43] However, nothing in GAAP, Sarbanes-Oxley, or other bookkeeping or reporting measures, would limit Verizon from allocating the unknown costs of the SpinCo properties in a manner favorable to Verizon. Rather, these are measures simply the means by which such

---

[39] *See* Exh. No. SGH-4 (emphasis added).
[40] Hill, TR. 424:6-13.
[41] *Id.* at TR. 605:13 – 606:21.
[42] *See* Smith, TR. 473:18 – 477:1. The only "rebuttal" offered by Verizon's witness, Mr. Smith, on this issue was indignation that Public Counsel would falsely accuse Verizon management of improper activity. However, Public Counsel's testimony makes no such accusation of nefarious activity or wrong-doing on the part of Verizon management. It is common sense that a seller, if able, will work within acceptable legal limits to extract the highest price for the goods being sold. Also, this Commission is quite familiar with the process of allocating corporate expenses and how the outcome of said allocations can change dramatically by choosing between two quite reasonable alternative methodologies.
[43] Smith, TR. 475:1-14.

allocations are recorded and calculated.

25. Indeed, evidence that the SpinCo carve-out was shaped in a manner favorable to Verizon is seen in the SpinCo balance sheet, showing very little debt capital and an "equity" component comprised of both parent company debt and equity. It is also notable that Frontier witness, Mr. David Whitehouse, indicated that the balance sheet appearing in the SpinCo Financial Statements was the result of a "negotiation" between Frontier and Verizon, not an allocation.[44]

3. Frontier is a needy buyer and has not looked behind the valuations provided by Verizon.

26. Verizon's sale valuation is also likely to be overstated because Frontier needs this sale to strengthen its financial standings, and thus was not in a strong negotiating position.[45] Frontier's Board of Directors made a decision it would make an acquisition prior to any actual deal, and was pursuing such a deal on numerous fronts.[46] Verizon, on the other hand, was not shopping the SpinCo properties for sale when it was contacted by Frontier.

27. A review of the timeline of negotiations highlights the disparity between the companies' bargaining positions. First, the speed with which the deal was constructed was dizzying. According to Frontier's S-4, at the beginning of 2009, Frontier was in negotiations with another telecommunications firm regarding purchase of its operations.[47] It was during this period that Frontier's CEO, Maggie Wilderotter, cold-called Verizon's CEO, Ivan Seidenberg, about a possible sale, and scheduled a meeting for the following month. In the meantime, the negotiations with the other telecommunications firm failed to progress. On March 11, 2009, Ms.

---

[44] Exh. No. DW-22.
[45] Frontier's financial metrics are worsening and it needs this deal in order to bolster its declining revenues, even if the deal's purchase price exceeds the value of the operations. *See* Exh. No. SGH-1HCT, p. 32:4-6 (Hill Direct).
[46] Exh. No. DM-7, pp. 46-47.
[47] *Id.*

Wilderotter and Mr. Seidenberg met to discuss this transaction for the first time. Only *two months later*, on May 13, 2009, the Merger Agreement was signed by Verizon and Frontier.[48]

28. Frontier's rush to find a suitor and its deteriorating financial situation underscores Verizon's ability to extract a price for its assets that is likely to exceed their value. It also explains why Frontier has repeatedly responded in discovery that it made no physical inspection of the facilities it hopes to buy.[49] It is as if Frontier is buying a house at the seller's asking price without an appraisal, or buying a used car without a mechanic's assessment. This failure to conduct a basic assessment of the properties also attests to Frontier's single-mindedness in simply getting a deal—any deal—to address its declining financial situation.

C. Frontier Lacks the Financial Capability to Operate in Washington.

29. Given Frontier's ambitious plans to acquire operations over three times its current size and make substantial investments in these new properties, Frontier's current financial condition must be fully understood by the Commission. If Frontier is not financially sound, it will be unable to provide adequate wireline service in Washington, let alone be incented to act through monetary service quality penalties, or be able to keep the numerous commitments it has made here and in other states.[50] Indeed, the Company's historical financial information paints the picture of a weak company very eager to make a deal to acquire additional sources of cash that may, for a time, stem the tide of its failing earnings.

/ /

/ / /

---

[48] *Id.*

[49] *Id.*

[50] For example, Staff confirmed that it is not possible to say whether a future bankruptcy would affect the escrow account for broadband deployment. *See* TR. 337:2-4 (Weinman). *See also* Exh. No. SGH-28, p. 33 ("penalties cannot cause compliance if the provider is financially unable to comply").

30. Unlike Verizon, Frontier, does not have an investment-grade bond rating.[51] As described by Mr. Whitehouse, an investment-grade rating gives companies "better access to the capital markets,"[52] a central item in this Commission's evaluation of proposed sales.[53] Moreover, Staff confirmed that a non-investment grade company is more likely to default.[54] It makes sense, then, that in the past, this Commission has gone to great lengths to prevent regulated utilities' ratings from dropping below-investment grade.[55]

31. While Frontier has expressed hope for a ratings upgrade,[56] it has not provided any reliable evidence that its hope will come to pass. The Company chose not to have rating agencies review its financial model or credit metrics, and thus could not provide a rating agency letter ruling to give assurance to the Commission regarding its assertions.[57] In addition, Frontier indicated that any upgrade it does achieve will not come quickly because it would not even *seek* a ratings upgrade until after synergies are realized which may not be for several years.[58] Moreover, while Frontier touts the fact that it has been put on positive outlook from two rating agencies,[59] it fails to mention the thirteen other investor services all of whom have not changed their outlooks,[60] or that Standards & Poor's reported that they may upgrade *or* downgrade Frontier after the merger,[61] and that one stock analyst recently downgraded the Company from

---

[51] Weinman, TR. 259:4-7. While Verizon has an investment-grade "A" rating, Frontier is below-investment grade with a "BB" rating. *See* Exh. No. SGH-1HCT, pp. 21:12-13 and 22:12-13 (Hill Direct).
[52] Whitehouse, TR. 557:17-19.
[53] The Commission has previously evaluated whether a proposed sale would diminish the utility's ability to access capital on reasonable terms, stating that diminished access would constitute a harm. *See PSE Sale,* Order No. 8, ¶¶ 117 and 144.
[54] Weinman, TR. 259:8-11.
[55] *Id.* at 259:12-16.
[56] Whitehouse, TR. 493:21-494:4; 557:16-23
[57] *Id.* at 553:14-21.
[58] *Id.* at 493:11 – 494:4; *see infra* n. 142.
[59] Whitehouse, TR. 494:5-8.
[60] McCarthy, TR. 540:15-22.
[61] Whitehouse, TR. 512:11 – 513:1.

neutral to underperform.[62] Finally, even if Frontier achieves the higher bond ratings it hopes for (a low-level investment grade), it will still remain a lower-rated company than Verizon.

32. Testimony at hearing has demonstrated that the financial weakness of Frontier extends beyond the fact that Frontier is, and will remain for some time, a junk-rated company. Other evidence of Frontier's financial weakness include its year-over-year decline in earnings, dwindling common equity; a 20 percent plunge in operating income from continuing operations in the last two years, and the future impact of increasing rates of line loss.[63] Indeed, just last year, Frontier instituted a mandatory furlough for all employees to bolster its declining income.[64] It is important to understand that Frontier's financial deterioration continued through the time period during which it acquired significant additional telephone access lines, and hence cash flow, from Commonwealth Telephone.

33. At the same time that its earnings have declined, Frontier has payed out dividends that are more than twice its earnings, ultimately reducing its common equity to *eight percent* of total capital in June, 2009.[65] Frontier currently has *the highest* dividend in the Fortune 1,000 companies (13.7 percent), which further illustrates how "risky" a company it is.[66] Frontier's promise to reduce dividends post-merger by 25 percent is cold comfort because, to complete this transaction, it will be issuing 750 million new shares, resulting in hundreds of millions in *additional* dividend payments.[67]

---

[62] *Id.* at 541:17-19.
[63] Hill, TR. 423:15-23.
[64] *Id.* at 423:14-424:4.
[65] *Id.* at 644:24 – 645:16.
[66] *Id.* at 644:24 – 645:16.
[67] *Id.* at 657:14-17. The share issuance will mean Frontier would pay an additional $562,500,000 in dividends quarterly (750 million shares x $0.75/share = $562.5 Million).

D. Frontier's Financial Projections are Overly Optimistic, Unsupported, and Untested.

34. In its recent article regarding acquisitions of wireline telecommunications services, the National Regulatory Research Institute (NRRI) cautions regulators regarding overly optimistic financial projections:

> When the buyer presents its financial projections showing an expectation of profitability and stability in the post-acquisition years, it makes certain assumptions about costs and revenues. Since the future of the business depends on the quality of these assumptions, the regulator must validate them. On the cost side, when the buyer has only limited knowledge of the condition of the business it is acquiring, it will likely encounter major unanticipated expenses. If it is overconfident about its changes of transforming a declining business, it will overestimate revenues and underestimate costs.
>
> There were instances of overoptimistic assumptions that gave regulator pause in their review of the Verizon-FairPoint transfer. Regulators rejected some of these assumptions, and tempered others by subjecting them to sensitivity analyses. As in other areas of financial analysis, where the costs and revenues resulting from the business expansion [are] larger than the size of the original business, the buyer's financial health is sensitive to faulty cost or revenue predictions.[68]

35. In this case, Frontier's financial projections are boldly optimistic, including a 30 percent reduction in the rate of line loss for SpinCo, an 85 percent increase in HSI penetration, a 37 percent increase in long distance penetration, a 47 percent increase in revenue, and a 70 percent increase in EBITDA per line for SpinCo.[69] This is troubling given that (1) the projections were created with a model that cannot be tested, (2) the projections are based on unvetted allocations from Verizon, (3) Frontier did not conduct any physical due diligence in Washington, and (4) Frontier has failed to properly assess future capital expenditures necessary in Washington.

/ /

/ / /

---

[68] Exh. No. SGH-28, p. 18 (internal citations omitted).
[69] Hill, TR. 425:9-17, and Exh. No. SGH-1HCT, pp. 34:14-20, 37:4-7 (Note: percentage changes do not reveal highly confidential data on which they are based).

1. Frontier has provided a financial model that cannot be altered or tested.

36. The financial model supplied by Frontier to Public Counsel and this Commission was a "locked-down" version of a larger and more fully-functioning financial model. The supplied model allowed changes to only *five* of the thousands of inputs the model contained,[70] even though Public Counsel repeatedly requested a fully-functioning model..[71] Thus, Frontier has not provided any results of "stress testing" the model's assumptions, and no party has been allowed to analyze the impacts that variations in line loss,[72] operating expenses,[73] capital expenditures,[74] revenue projections,[75] or synergy savings, may have on Frontier's post-sale financial projections and the ultimate financial viability of a post-sale Frontier. This is despite the fact that the record evidence shows that (1) line loss may not slow (as assumed) and, in fact, may be higher than what Verizon is currently experiencing,[76] (2) that Frontier may have to make substantial additional expenditures beyond those assumed to repair and maintain plant and meet its build-out

---

[70] Whitehouse, TR. 506:15-507:4, Mr. Whitehouse, Frontier Treasurer and Chief Financial Officer, testified:

> Q: So you just said that there were thousands of cells, and of those, five of the parameters could actually be change; is that correct?
>
> A: I believe in the version you have...
>
> ...
>
> Q: So there's a version that is actually more functioning . . . than the one you provided to Public Counsel; is that correct?
>
> A: No, I'm not saying that. The model is what it is. That is the model that we provided to every state and to everyone who's requested it. But there is no model that would allow you the ability to run iterations.

[71] Hill, TR. 425:9-17.

[72] Whitehouse, TR. 509:14-18; Mr. Whitehouse, testified:

> Q: And it also was not possible in the model that . . . Frontier management used to change the rate of line loss for the VSTO SpinCo or legacy Frontier properties?
>
> A: That is correct.

[73] Whitehouse, TR. 510:19-22, Mr. Whitehouse testified:

> Q: Could the parameters for SpinCo, VSTO, or legacy Frontier be changed for operating expenses?
>
> A: No, I believe – no, they could not.

[74] *Id.* at 510:23 – 511:16.

[75] *Id.* at 507:24 – 508:18.

[76] Exh. No. DM-7, p. 29-30; Also, prior to Frontier's acquisition of Commonwealth in 2007, its annual rate of access line loss was 4.5 percent. Following, that acquisition, even with increases in the number of high-speed internet (HSI) customers, the rate of line loss for Frontier has increased. This latter fact does great damage to the Company's "business model" claim that, by extending high-speed internet availability it will be able to stem the tide of access

commitments,[77] and (3) that the extent and timing of its synergy savings are uncertain.[78] The inability of this Commission to scrutinize the impact of changes in the assumptions on which the financial model is based raises grave concerns regarding the reliability of Frontier's actual financial projections.[79]

37. Also troubling is the fact Frontier *intended* its model to be non-functioning for third parties, *i.e*,. ensuring that third parties would not be able to test its boldly optimistic financial projections. Mr. Whitehouse testified at hearing that Frontier's model "was never developed for the intention of third part[ies] . . . to use," and that "it's not prudent to have a model that is just floating around with everyone putting different assumptions."[80] As Mr. Whitehouse noted, the model was "locked down" before it was given to the parties in this proceeding and other regulatory bodies.

2. Frontier's financial model and projections are based on the unvetted allocations provided by Verizon.

38. The accounting assumptions and allocation processes used to "carve out" SpinCo impact nearly every financial aspect of this case. Yet, as mentioned previously, these assumptions and allocation processes have not been verified or tested by any party.[81] The fact that Verizon management's carve-out of the SpinCo properties was not vetted in an arms-length manner is problematic for two primary reasons.

---

line loss; the historical evidence contained in Frontier's own published financial reports show that, despite higher HSI investment, access line loss has been accelerating. *See* Exh. No. SGH-1HCT, p. 21:3-11 (Hill Direct).

[77] Exh. No. DM-7, p. 34;

[78] *Id.* at p. 25.

[79] In order to effectively evaluate a transaction such as this, the regulator must be able to validate those financial projections. *See* Exh. No. SHG-28, p. 26. In this proceeding, Frontier has prevented any detailed analysis of its financial projections, and , once again, the Commission is being asked to approve this transaction on faith, not analysis.

[80] Whitehouse, TR. 506:7-9 and 511:2-5.

[81] Exh. No. SGH-1HCT, p. 25:30-31 (Hill Direct); Hill, TR. 648:15 – 652:12.

39. First, the total valuation of the properties is based to a substantial extent on the projected 2010 Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). The higher the allocated EBITDA for SpinCo, the higher the value of the transaction to Verizon, and the increased probability of negative financial outcomes for Frontier. Second, the financial projections for this transaction utilize the allocated 2010 EBITDA for SpinCo as a "launching pad" for the combined company financial projections through 2014. If the 2010 EBITDA is overstated (which is likely), the financial risk of the transaction must be considered to be greatly understated.

40. The evidence suggests that, indeed, the 2010 EBITDA is overstated. As Mr. Hill noted in his Direct Testimony, the SpinCo balance sheet shows very little debt capital because masquerading as equity capital is something labeled "parent funding."[82] According to Note 7 on the SpinCo Financial Statements, "parent funding" is both debt *and* equity capital.[83] Therefore, the SpinCo capital structure that is the result of Verizon management's unvetted allocations is "shaped" to show very little debt capital, while including other debt as "parent capital." This has the impact of making the whole transaction look less leveraged than it really is.

3. Frontier failed to conduct physical due diligence on properties it hopes to acquire.

41. Frontier did not conduct any physical due diligence to verify the value of Verizon's Washington assets or determine whether additional capital expenditures would be necessary. This again calls into question the high purchase price and accuracy of Frontier's financial

[82] Exh. No. SGH-1HCT, p. 27:16-28:2, n.20.
[83] *Id*; Hill, TR. 650:8-20.

projections. Only at the eleventh hour did Frontier indicate that it had made "visits" to some of the Verizon facilities in Washington.[84] However, Frontier has not provided any physical record of those visits nor any lists of the personnel involved, the plant reviewed, or indication of the plant conditions, as requested.[85]

42. There is reason to believe that the essential plant may require substantial costly repairs.[86] First, Verizon has provided no evidence of the actual condition of its plant; instead asserting that plant condition must be satisfactory since the Company's service quality reports do not show problems.[87] Frontier, on the other hand, warned its stockholders that one risk of the proposed sale relates to the condition of the SpinCo properties because, with regard to those properties, Verizon has invested at a "significantly lower" rate than has Frontier.[88] Finally, Verizon's own engineers admit that the Verizon's local exchange telephone infrastructure requires substantial investment for DSL deployment.[89]

4. The proposed sale does not provide for sufficient capital expenditures.

43. Frontier has not developed a capital budget for Washington.[90] What was provided in last-minute fashion was merely a state-based allocation of what Frontier projects spending nationwide.[91] This allocation shows that Frontier anticipates spending far less than Verizon's

---

[84] Exh. No. DM-87; Roycroft, TR. 678:10-19.
[85] Roycroft, TR. 678:10-19.
[86] Exh. No. DM-7, p.34; *see also,* testimony provided at the October 15, 2009 Public Hearing by Verizon Northwest employees, including, Joseph Loo (TR. 61:18-63:8), James Hutchinson (TR. 69:9-70:24), and Steve Walcker (TR. 8:6-12).
[87] McCallion, TR. 376:2-4.
[88] Exh. No. DM-73. Testimony at the Public Comment hearing gave examples of two specific problems. TR 61,62, 69-73, and 86-87. When these problems were subsequently investigated, both turned out to be real and required substantial repairs. *See* McCallion, TR. 351:5-352:16.
[89] Exh. No. SES-25HC.
[90] Exh. No. DM-86; McCarthy, TR. 395:18-20 (Frontier witness, Mr. McCarthy, stating that the company has "been consistent all along that we do not have the budget developed").
[91] McCarthy, TR. 396:10-397:5.

recent spending in Washington. Specifically, while Verizon spent **[Begin Highly Confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX[92] **[End Highly Confidential]**, Frontier anticipates spending only $55 million to $60 million per-year beyond the remaining FiOS commitments and the $40 million broadband escrow amount.[93]

44. This comparison shows that Frontier's anticipated capital spending in Washington is well below Verizon's historical experience. Moreover, to meet the types of deployment goals Frontier relies on to show that it is a financially viable provider,[94] *i.e.*, stem line loss and maintain revenues, it is highly likely that Frontier will have to spend far greater than it anticipates.[95]

E. Frontier is not Well-Suited to Meet the Challenges of the Changing Wireline Market.

45. Across the industry, telecommunications providers like Verizon and Frontier have experienced declines in switched access line counts.[96] This environment increases the risks for wireline operators as they must recover the largely fixed costs of their operations from a shrinking customer base. This market shift must be kept in mind when evaluating the request to

---

[92] Exh, No. TM-26HC.

[93] These amounts are based on the Washington-state allocation (12 percent) of Frontier's anticipated revenues. *See* McCarthy, TR. 396:1-5 and 396:21 – 397:6. Notably, Frontier does not anticipate continuing the level of fiber investments made by Verizon beyond the currently-existing commitments, a benefit to Washington that will be lost should the sale be approved.

[94] Frontier has stated that its revenue projections and business focus are based deploying broadband, particularly to stem line loss. Saville, TR. 209:6-8; McCarthy, TR. 346:23-347:8; Exh. No. DM-1T, p.20:12-19 (McCarthy Direct).

[95] The broadband escrow has been described by Commission Staff as a "down payment." Weinman, TR. 525:3-17 ("when we look at what the company actually has to do . . . the percentage of [required] availability dictates the final amount of money needed to be expenses by the company to meet this settlement. The $40 million, like I said, I believe is a down payment"). It is also set aside to target high-cost deployment in unserved and underserved areas that would not otherwise occur. *See* Exh. No. DM/TM-1T, p. 17:21-22 (McCarthy/McCallion Supporting). In other words, deployment above and beyond what Frontier should do in the normal course of business

[96] For example, in recent years Frontier has experienced average switched line loss of about 7 percent per year, and Verizon access line counts in the SpinCo service area have declined by 10 percent per year. *See* Exh. No. DM-1T, p. 11:6-8 (McCarthy Direct).

transfer the assets that Verizon no longer views as profitable to the much smaller, less diversified Frontier.

46. Verizon and Frontier offer two very different business strategies to address wireline losses. Verizon, on one hand, has pursued service diversification. For example, in addition to its wireline operations, Verizon is also one of the two largest US wireless carriers. Verizon's network upgrades to enable broadband Internet access also provide new revenue streams and a means to retain customers. In addition, Verizon has pursued video-delivery strategies by upgrading portions of its networks, including the FiOS build-out in Washington, to enable the provision of video services. These diversification efforts have allowed Verizon to mitigate some of the negative impact of the wireline losses,[97] and has resulted in Verizon continuing as an investment-grade company.[98]

47. In contrast, Frontier is pursuing an arguably less effective, two-prong approach to address negative trends. First, Frontier believes that it can improve its operating results through acquisitions, as is evidenced by this proceeding and other recent Frontier transactions. Frontier is apparently pursuing an aggressive growth strategy, and plans to continue acquiring access lines following this transaction.[99] The second prong of Frontier's approach is to increase revenues associated with the SpinCo operations.[100] Frontier believes that it can improve the revenue profile of its new SpinCo customers through aggressive marketing:

> The combined company will utilize targeted and innovative promotions to attract new customers, including those moving into the combined company's territory,

---

[97] As described by Mr. Hill at hearing (TR. 626:4 – 627 18):

> Verizon's financial metrics are . . . very positive. They're going in the opposite direction of Frontier's. . . . And simply put, they have the financial capacity to support this business in Washington. . . . [Verizon] has the financial wherewithal to do what's necessary to build the network that needs to be built in Washington, and we're not frankly sure that Frontier can do that.

[98] Exh. No. TRR-1HCT, p. 21:16-17 (Roycroft Direct).

[99] *Id.* at p. 24:4-6.

[100] Exh. No. DM-4, p. 158 (McCarthy Rebuttal).

> win back former customers, upgrade and up-sell existing customers on a variety of service offerings including HSI (high-speed Internet), video, and enhanced long distance and feature packages in order to maximize the average revenue per access line (wallet share) paid to the combined company.[101]

However, it is questionable whether this approach works. As Mr. Hill bluntly stated at hearing:

> If [Frontier's business model] were working, then . . . [its] line losses wouldn't be increasing, they would be stabilizing, and they're not. So unless [it is] able to keep making deals like this, I'm not sure how Frontier makes this a stable situation over the long haul.[102]

48. The proposed sale would thus present Washington ratepayers with a substantial negative shift in the operational approach, and serious operational risks associated with their provider of voice telephone and broadband services. Simply put, Washington ratepayers are "better off" with Verizon.[103]

F. The Myth of the Reluctant Service Provider.

49. Should this Commission reject the proposed sale, Verizon will remain the certificated incumbent carrier in its service area. As noted in questions posed by Chairman Goltz, some have stated that rejecting this sale could generate a situation where "Verizon does not want to be here."[104] According to Staff Witness, William Weinman, Verizon's potential reluctance may create "risk."[105]

50. The Commission should not be distracted by the argument that Verizon would be a "reluctant" ILEC.[106] As the incumbent carrier, Verizon has a legal obligation to provide

---

[101] *Id.*
[102] Hill, TR. 628:18-23.
[103] *Id.* at 626:10-11.
[104] TR. 363:5-9.
[105] Weinman, TR. 363:5-9.
[106] Public Counsel Witness, Ms. Alexander, testified to this point (TR. 621:3-12):

> Q: Would you agree that, I guess for lack of a better term, that willingness of the service provider is a factor that we should consider?
> A: I would hesitate to say yes to your questions because it almost makes it appear as if the regulatory process and the obligations that flow from Verizon's obligations under its certificate of

service.[107] Moreover, the service that Verizon is obligated to provide must meet the quality standards set by the Commission and those laid out in its own tariff.[108] The Commission has ample authority to enforce those obligations. In sum, Verizon's legal obligations ensure that there is no risk of harm from "reluctance" any company may have to provide high quality services.

51. Moreover, Verizon has gone to lengths to show that its service quality in Washington has remained at acceptable levels. At hearing, Mr. McCallion testified:

> Verizon has provided very good service to its customers, as the Commission can see from the service results that we report to the Commission. We've continued to invest in our network over the years in addition to, for example, in making a very significant investment in fiber to the premise. And the numbers are confidential, but it's in the hundreds of millions of dollars of investment that we've done just

---

convenience . . . [are] somehow solely up to their discretion, and I guess I'm not sure I would agree to the implications of that question.

The previously mentioned NRRI article discusses the possibility of a "reluctant incumbent" if the proposed sale is rejected (Exh. No. SGH-28, pp. 30-31 (internal citations omitted)):

> With the rejection of a proposed sale of exchanges, regulators then must confront the challenge of regulating an incumbent that has sought to terminate its public service obligations. At one level, the rejection simply means a continuation of the status quo. Whatever regulation has applied to the ILEC with respect to rates, quality of service, and other public service obligations continues uninterrupted. As a practical matter, however, if the ILEC has determined that its best investment opportunities lie elsewhere, the regulator should pay special attention to the incumbent's performance. The investigation of a proposed transfer can also bring to light specific deficiencies in the ILEC's ongoing performance of its public service obligations (e.g., with respect to service quality), particularly if it has decreased its investments in anticipation of selling the assets. The public interest requires a prompt and direct response to any such problems, even if it is clear that the ILEC intends to renew its efforts to find an acceptable buyer and continue to pursue its exit strategy.
>
> The regulator might be able to streamline future proceedings and improve the chances of a positive public interest outcome by working with the incumbent to develop an understanding of the type of buyer and the type of transaction that will attain regulatory approval. Such an approach neither binds the regulator nor substitutes for careful ongoing regulation, so long as the ILEC retains its utility status. However, it could provide an otherwise reluctant incumbent with an incentive to maintain its infrastructure and provide high quality-service until a transfer can be arranged that meets the public interest.

[107] The ILEC's obligation to serve is codified at RCW 80.36.090, which states in pertinent part:

> Every telecommunications company shall, upon reasonable notice, furnish to all persons and corporations who may apply therefore and be reasonably entitled thereto suitable and proper facilities and connections for telephonic communication and furnish telephone service as demanded.

[108] *See* Exh. Nos. KMR-3 and KMR-4.

> for FiOS for our customers. In addition to that, we've maintained our core network on a very good basis as the service quality results show.[109]

Verizon's past performance does not support assertions that it is reluctant to serve Washington, or that any reluctance on its part would actually result in harm. Verizon's continued investment in Washington contradicts assertions that it is "reluctant" to serve. That Verizon has targeted Washington for FiOS deployment and expended "hundreds of millions of dollars" does not paint a picture of a disinterested service provider.[110] Rather, Verizon has been pursuing its new "core" business model in Washington of building out a fiber-based network that is capable of delivering video services, as described by Verizon CEO, Mr. Seidenberg.[111] Verizon's Washington property stands out among the other SpinCo properties, both with regard to the deployment of FiOS[112] and DSL.[113] These facts point to a company with a continued interest in the state.

52. In addition, the definition of a "reluctant" service provider is not clear. If the Commission rejects the proposed sale, Verizon could retain its Washington operations, just as it is retaining the bulk of its California operations. If Verizon remains the ILEC in Washington, how would any "reluctance" to serve manifest? Would Verizon no longer invest in Washington, even if it faced profitable investment opportunities? Would Verizon allow the maintenance of its outside plant to degrade? Would Verizon allow its service quality to decline? If such events were to occur, this Commission certainly has the authority to respond appropriately. Finally, if

---

[109] McCallion, TR. 375:18-376:2. *See also* McCallion, TR. 470:19-22.

[110] *Id.* at 375:21-376:2. Assertions have been made that wireline service in non-dense areas is no longer in keeping with Verizon's "core" business model. However, when compared to other Verizon properties, Verizon's business plans in Washington have been much closer to Verizon's new core values. As noted by Mr. McCallion:

> We've continued to invest in our network over the years in addition to, for example, in making a very significant investment in fiber to the premise. And the numbers are confidential, but it's in the hundreds of millions of dollars of investment that we've done just for FiOS for our customers.

[111] Exh. No. TRR-1HCT, p. 22:10-23 (Roycroft Direct).

[112] Roycroft, TR. 447:14-20.

this proposed sale is rejected and Verizon still wishes to divest itself of the Washington property, it could find another buyer, better positioned than Frontier to satisfy the statutory requirements and the Commission's standards for merger review.[114]

V. THE PROPOSED SETTLEMENTS ARE NOT IN THE PUBLIC INTEREST

53. The proposed settlements between Staff and the Joint Applicants (the Settlement), and between DoD/FEA and the Joint Applicants (FEA Settlement), do not meet the standard for approval of the proposed sale.[115] These settlements provide no assurance of Frontier's managerial and financial capability, lack adequate protections against service quality deteriorations and higher rates, and provide no assurance that potential synergies will be shared with ratepayers.[116] Moreover, the purported "benefits" are minimal and do not offset the very real harms of the sale.[117] Accordingly, Public Counsel recommends that the settlements, and sale, be rejected.

A. Financial Conditions.

54. The evidence shows that Frontier lacks the financial capability to satisfy the public interest standard. In direct testimony, Staff and Public Counsel discussed Frontier's financial weakness at length. The financial conditions contained in the Settlement do not remedy the fundamental problems associated with those financial weaknesses.

---

[113] Exh. No. TRR-1HCT, p. 83:12-18 (Roycroft Direct).
[114] Exh. No. SGH-28, p. 30-31.
[115] To determine whether a proposed settlement is in the public interest, the Commission "analyze[s] the transaction's details, the risks of harm to the public interest, and whether the Settlement's commitments are adequate to protect against those risks." *PSE Sale,* Order No. 08, ¶ 116.
[116] *See supra* Section III, describing the standard for merger review and approval.
[117] If the potential harms to the public outweigh the benefits to the public, the Commission must deny the sale or condition the approval in a manner that ensures no net harm results. *See id.*

1. Staff's change in position is unsupported.

55. In its testimony supporting the Settlement, Staff states that the Joint Applicants provided evidence in their rebuttal filing that addressed Staff's previous concerns regarding Frontier's financial capability.[118] In fact, neither in their rebuttal case, nor in discovery, did the Joint Applicants provide such evidence. Five examples follow. First, Staff previously stated that Frontier's below-investment-grade rating presented a harm or risk of harm to Washington ratepayers.[119] Frontier's low rating is neither changed by the rebuttal evidence nor by the terms of the Settlement.[120] Second, Staff noted that Frontier's practice of paying up to 70 percent of its free cash flows in dividends was inconsistent with the Company's capital expenditure program and detrimental to improving its financial position.[121] Again, this concern is neither addressed by the evidence on the record nor any settlement condition.[122] Third, Staff's concern that Frontier will not have as broad a product line as Verizon to help offset line loss is also unchanged by any evidence on the record.[123] Fourth, Staff cited the fact that Frontier had not supplied a capital budget for Washington in support of its initial recommendation that the sale be rejected. At hearing, Staff confirmed that Frontier still has no such budget.[124] Finally, in its direct testimony, Staff listed the lack of certainty regarding the $3.3 billion debt covenant as a major financial concern. Again, Staff confirmed at the hearing that it had not been provided

---

[118] Exh. No. WHW-14T, pp. 3:20-4:2 (Weinman Supporting); Exh. No. WHW-15.
[119] Exh. No. WHW-1T, p. 8:15-16 (stating, "there are financial risks that are likely to cause harm to the Verizon NW Washington customers because Frontier has a lower debt rating than Verizon") (Weinman Direct).
[120] Weinman, TR. 258:23-259:259.
[121] Exh. No. WHW-1T, p. 9 (Weinman Direct).
[122] Weinman, TR. 262:6-24 (confirming that there is no evidence that Frontier must or will reduce dividends to match earnings, only the reduction that it plans to reduce dividends as a part of the deal, but that this dividend amount will still be in excess of earnings).
[123] Weinman, TR. 266:18-267-1.
[124] *Id.* at 267:2-268:10.

evidence addressing the uncertainty of the debt covenant, indicating that the conditions leading to Staff's previously stated concern had not changed.[125]

56. Despite these unaddressed concerns, Staff did little of its own analysis of Frontier's financial capabilities before entering into settlement. For example, Staff performed no analysis regarding Frontier's financial health in the event the Company does not meet its synergy targets, experiences unexpected costs associated with repairing or upgrading outside plant,[126] or fails to achieve DSL subscription above Verizon's current level.[127] When pressed on this issue, Staff also confirmed that it had not "done any calculation with reliable data on line loss."[128] Finally, Staff has done no analyses similar to those the Oregon Commission recently declared were essential to determining whether the proposed sale (even with numerous conditions) was in the public interest.[129] This lack of analysis by Staff should be taken into account in evaluating Staff support for the Settlement.

2. The financial reporting requirements do not alleviate the financial harms or risks of the proposed sale.

57. The Settlement contains reporting requirements in the following areas: (1) cash flows between Frontier's operating and parent companies; (2) synergy savings, if any; (3) organizational changes to network operations and staffing levels; (4) the actual debt to EBIDTA ratio after the sale; (5) affiliated interest transactions; (6) any pre-close changes in the Merger Agreement; and,

---

[125] *Id.* at 268:12-20.
[126] *Id.* at 275:18-276:15.
[127] *Id.* at 275:12-17.
[128] *Id.* at 390:10-13.
[129] *Id.* at 277:16 – 279:1. The Oregon Commission stated in a post-hearing bench request that, "upon review of the testimony provided in response, the Commission is still concerned that it has insufficient information upon which it might be able to conclude that the Applicants have met the 'no harm' standard required for approval." The Oregon Commission then required the Joint Applicants to provide substantial additional information regarding Frontier's

(7) plans and budgets for replacing switches.[130] However, the reporting requirements are only just that, and include no limits, conditions, triggers for action, consequences, or actual protections. For example, while Staff and Frontier state that ratepayers should share in the synergy savings,[131] the Settlement only requires that Frontier file reports on synergies and lacks any trigger for regulatory action or provision for sharing savings.[132] As Mr. Hill observed at hearing, these requirements place the Commission in the position of "watching the fish swim by" without "trying to catch anything."[133]

3. The Settlement's condition requiring that Frontier impute an investment-grade cost of capital in its future earnings review does not alleviate the financial harms of the proposed sale.

58. While setting rates in the future based on an investment-grade cost of capital would appear, in the short-term, to protect ratepayers from unnecessary rate increases due to higher capital costs, such protection is merely illusory.[134] Regardless of whether an investment-grade cost of capital is imputed in the ratemaking process, the fact remains that Frontier is a risky company. While the parties may hope they can overlook that fact in the ratemaking process, the reality is that Frontier will have a significantly higher cost of capital than an investment-grade

---

financial projections under various different scenarios, and the likely costs of different levels of broadband deployment. *See* Exh. No. WHW-35. The Joint Applicants have not provided similar information in Washington.

[130] Exh. No. 2HC, Attachment 1 ¶¶ 1, 3, 6, 7-9, and 12.

[131] McCarthy, TR. 359:21-25; Weinman, TR. 360:1-3.

[132] Hill, TR. 431:3-8. The settling parties assert that the earnings review to be filed with the AFOR application will provide the opportunity for capturing synergy savings. *See* McCarthy and Weinman, TR. 358:19 – 360:3. However, as discussed in Section V.A.4, the timing and scope of the review are insufficient to assure that synergy savings are realized, reflected, and passed on to ratepayers.

[133] Hill, TR. 430:12-13.

[134] Exh. No. 2HC, Attachment 1 ¶ 2; Exh. No. WHW-14T, p. 4:13-21 (stating, "[t]his provision eliminates the cost of capital issue") (Weinman Supporting).

company. Imputing a lower-than-actual cost of capital could result in Frontier not collecting sufficient rates to cover its actual costs, thereby further weakening it financially. Given its already precarious financials, allowing this transaction, while at the same time further weakening Frontier's financial health, would only increase the probability of additional harms to ratepayers. If the rate structure required by this condition adds financial pressure to the post-merger firm, the resulting costs *will* eventually reach ratepayers, who are the "pockets" of last resort. Thus, such a condition provides only a short-term, illusory protection for ratepayers and illustrates the fundamental flaws of the proposed sale.

59. In addition, there are numerous practical difficulties that make application of this condition difficult at best, and leaves open the possibility for disagreement between even the settling parties at a later date. It is certainly possible to identify current investment-grade bond yields to use as the current marginal cost of debt in the ratemaking process, but the appropriate level to use in that process– Verizon's current A-rating or a marginal BBB- rating – is uncertain. The cost difference between the two could be substantial. Also, although it is always difficult to decide which companies are appropriate comparators for setting the cost of common equity capital, this determination would be even more difficult in the type of analysis envisioned by this provision. Furthermore, it is far from clear what capital structure would be appropriate for setting rates in this context. Would the appropriate capital structure be that of an A-rated company with a significant portion of high-cost equity capital, or would it be closer to the actual structure of Frontier at the time? Again, minor variations in capital structure could have substantial cost impacts for ratepayers.

4. Requiring Frontier to apply for an AFOR does not alleviate the financial harms and instead creates additional risks.

60. The Settlement requires Frontier to file a petition or an alternative form of regulation (AFOR)[135] within five years.[136] Although this requirement falls under the "Financial Conditions" heading of the Settlement, it offers neither financial protections nor benefits for Washington ratepayers.[137] Moreover, Frontier is free to apply for an AFOR at any time absent this condition and would likely favor doing so because, by its very nature, an AFOR reduces regulatory requirements. As Mr. Hill observed at hearing, "this is not really an onerous condition for a regulated utility . . . what utility wouldn't want to be less regulated?"[138]

61. One of Staff's justifications for this requirement is that the attendant earnings review will serve as a means of capturing synergy savings, should they occur.[139] However, given the relatively short window for filing, whether synergies could be properly accounted for at the time of the AFOR is doubtful.[140] Frontier could file after just three years,[141] even though it is uncertain whether it will have even begun to integrate operational systems at that time, and thus may have no synergies to reflect.[142] And once an AFOR takes effect, there might be no further ratemaking opportunity to capture synergy benefits for customers.

---

[135] RCW 80.36.135 (authorizing alternative regulation for telecommunications companies).
[136] Exh. No. 2HC, Attachment 1 ¶ 2.
[137] At hearing, Mr. Hill testified that the AFOR requirement doesn't have "really much of anything to do with protecting [Frontier's] finances." TR. 430:20-22.
[138] Hill, TR. 430:15-18.
[139] *See* Exh. No. WHW-19, p. 3.
[140] Roycroft, TR. 465:20 – 466:13.
[141] Weinman, TR. 355:17-23.
[142] Frontier stated in its S-4 (dated July 24, 2009) that, "[t]he combined company's success in realizing . . . synergies, and the timing of this realization, depends on the successful integration of Frontier's business and operations and the SpinCo business and operations." Exh. No. DM-7, p. 25. *See also* Exh. No. DM-8HCT, p. 37:16-17 (McCarthy Rebuttal) ("the synergies and cost savings will be realized . . . as the businesses are integrated to become more operationally efficient"). However, Frontier has repeatedly stated that it will be in no rush to integrate systems. Mr. McCarthy noted in his pre-filed Rebuttal Testimony: "Frontier will not be pressured to convert systems, as Verizon was never pressured to convert the GTE systems that it purchased . . . [which it] continued to operate for more than nine years" and that "Frontier has no timeline for migration." *Id.* at p. 45:2-8. In his Direct Testimony, Mr.

62. The AFOR provision introduces new risks for consumers, risks that were not contained in the initial proposal.[143] One very real risk of this provision is higher residential rates, which Staff confirmed "usually result[]" from such regulatory flexibility.[144] It is also likely that business customers would experience rate increases under an AFOR.[145] In addition, the earnings review proposed by Staff falls far short of a full rate case and would offer fewer procedural assurances that proper rates result.

B. DSL/Broadband Deployment and Terms.

63. Frontier asserts that it can stem line loss through the deployment of broadband.[146] By making this statement, Frontier illustrates the increasing importance of broadband to maintaining the viability of companies providing regulated basic telephone service. If the Commission approves this sale, it will be accepting Frontier's proposition that the solution to the line loss problem is extending the reach of broadband. Thus, this Commission must address the timing, scope, and quality of broadband deployment contained in the Settlement. Evaluation of the Settlement's provisions reveals *inadequate* broadband provisions.[147]

64. As the Commission is aware from the record in this proceeding, both Frontier and Verizon have experienced line loss in recent years.[148] More recent evidence presented at the hearing shows that the negative trend associated with line loss in the Verizon Washington service

---

McCarthy also pointed out that Frontier took seven years to integrate billing systems after a previous acquisition. Exh. No. DM-1T, pp. 45:20-46:1 (McCarthy Direct). Finally, Staff confirmed that there is no timeline for integration, and indeed "there is no guaranty that [it] will happen at all." Williamson, TR. 317:16-17.

[143] Roycroft, TR 466:2-466:5.

[144] Weinman, TR. 331:6-9.

[145] *Id.* at 332:7-18 (Commissioner Oshie stating his belief that under Qwest's AFOR, business customers are paying "at least the same, if not more, than they had under regulation").

[146] Exh. No. DM-1T, p. 20:15-19 (McCarthy Direct).

[147] The Settlement indicates that DSL deployment must eventually reach 89 percent of households, with 80 percent of those households capable of achieving 3 Mbps download speeds by the end of 2014. Exh. No. 2HC, Attachment 1 ¶¶ 15-16.

[148] Exh. No. DM-1T, p. 11: 5-8 (McCarthy Direct).

area has now accelerated, reaching **[Begin Highly Confidential]** XXXXXXXXXXX.[149] XX

XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

[End Highly Confidential] Given Frontier's generally weaker financial profile, whether Frontier can continue as a financially viable firm in light of line losses of this magnitude is a critical question that Frontier has not answered.[150]

65. At hearing, Public Counsel witness, Trevor Roycroft, identified a number of specific deficiencies associated with the Settlement's broadband provisions.[151] First, the Settlement's timeline for deployment is unacceptably long.[152] Its broadband objectives identified may not be completed until December 31, 2014—nearly five years from now.[153] It is notable that among the properties to be transferred, Washington has the highest level of DSL deployment.[154] Allowing Frontier five years to move a relatively short distance in terms of broadband deployment is an indicator of the weakness of the Settlement's broadband provisions.[155]

66. Second, Dr. Roycroft testified that the coverage associated with the broadband deployment is insufficient.[156] The Settlement gives Frontier five years to reach 89 percent of households with DSL service.[157] This is the *same* level of broadband deployment that is *currently* provided to CenturyTel customers, and *close to* the level of broadband deployment *currently*

---

[149] Highly Confidential Exh. No. TM-24HC.
[150] The impact of varying rates of line loss on Frontier's financial projections could not be considered in the version of the model provided by Frontier. *See supra* Section IV.D.1.
[151] Confounding these deficiencies is the fact that the Settlement's DSL "plan," including the operation of the escrow account, is vague and provides little guidance. *See* Weinman, TR. 338:19 – 340:23.
[152] Roycroft, TR. 455:22-23.
[153] Exh. No. 2HC, Attachment 1 ¶ 15.
[154] Roycroft, TR. 456:11-15.
[155] *Id.* at 455:19 – 456:4.
[156] *Id.* at 456:11 – 457:4.
[157] Exh. No. 2HC, Attachment 1 ¶ 15.

provided to Qwest customers in Washington (87 percent) coverage.[158] This objective is three percentage points *lower* than the 92 percent legacy Frontier coverage that Frontier has emphasized in this proceeding.[159] In other words, the Settlement provides a benchmark for achievement *five years from now* that is lower than the *current* legacy Frontier benchmark. In addition, the Settlement allows that, at the end of the five-year period, five wire centers can remain entirely unserved.[160]

67. Third, Dr. Roycroft testified that the grade of technology required by the Settlement is currently outdated, and by the time the commitments are fulfilled, will be antiquated.[161] The Settlement specifies that Frontier must make broadband available at speeds of 1.5 Mbps download and 381 kbps upload to 75 percent of the households by the end of 2011.[162] The Settlement also indicates that download speeds of 3 Mbps should be available to 80 percent of households by the end of 2014, *i.e.*, five years down the road. However, Frontier's current standard grade of broadband deployment is designed to provide 3 Mbps service.[163] Holding Frontier to this same 3 Mbps standard for five years applies a weak technological benchmark.[164]

68. To put the Settlement's broadband requirements in context, a recent report issued by Akamai, a global Internet distribution platform, found that the current average download speed in

---

[158] Exh. No. JL-1HCT, p. 8 (Table 1) (Liu Direct).
[159] *See* Exh. No. DM-8HCT, p. 19:12-14 (McCarthy Rebuttal).
[160] Exh. No. 2HC, Attachment 1 ¶ 15.
[161] Roycroft, TR. 457:9 – 458:20. The Telecommunications Act of 1996 specifies, in Section 706, that all Americans should have access to advanced telecommunications services, including "high-speed, switched, broadband telecommunications capability that enables users to originate and receive high-quality voice, data, graphics, and video." The Act also instructs state commissions to take actions to achieve these objectives.
[162] Exh. No. 2HC, Attachment 1 ¶ 16.
[163] *See* Exh. No. BJG-1T, p. 26:10-11 (Gregg Rebuttal).
[164] Roycroft, TR. 458:9-20. Notably, Frontier Witness, Billy Jack Gregg, told this Commission that, while Frontier's standard broadband deployment is 3 Mbps, Frontier deploys broadband at higher speeds in some areas. Exh. No. BJG-1T, p. 26:10-12 (Gregg Rebuttal).

the United States is 3.9 Mbps.[165] This average speed places the United States in 18th place globally.[166] Locking in Washington consumers—five years from now—to a standard that is *lower* than the download speeds that currently rank 18th globally is unacceptable. The broadband provision is especially unacceptable as the Settlement allows Frontier to keep an overwhelming majority of the expected synergies that Frontier has associated with this sale.

69. Additionally, the Settlement's broadband provisions may undermine the policy objectives of this Commission. In the Verizon/MCI merger case, the Commission noted:

> Intermodal competition may well provide a check on future anticompetitive outcomes in the local exchange market, but for this to be a viable check in a consolidating and converging industry, consumers must have unfettered access to competitive VOIP services. Customers' access to competitors' VOIP over Verizon's DSL service is crucial to protecting consumer choice as intermodal competition increases. Ensuring this access is central to this *Commission's obligation to support state policy to advance the efficiency of telecommunications service and to promote diversity in the supply* of telecommunications services and products in telecommunications markets throughout the state.[167]

70. This statement contains a key policy directive with regard to DSL services, *i.e.*, that the Commission has an obligation to support advances in the efficiency of telecommunications service and to promote diversity in the supply of telecommunications services and products. The diversity of supply identified by the Commission in the quotation above is equally valid in this case. For those consumers who do not currently have access to DSL service in Verizon's service area, the ability to choose an alternative source of voice services, such as those made available through VoIP, may be limited if not impossible. Thus, a timely expansion of high-quality broadband services will positively impact this stated policy objective.

---

[165] Exh. No. TRR-27, p. 10.
[166] *Id.*
[167] *Verizon-MCI,* Order No. 07, ¶ 149 (emphasis added).

71. The Commission's decision regarding whether to approve the Settlement (and sale) will have impact on the "diversity in supply" as well. Given the negative trends in line loss, the Commission must concern itself with the viability of companies, like Frontier, that provide both DSL and basic telephone service. Frontier believes that it can stem line loss by providing broadband service. If Frontier cannot stem line losses, it will be hard-pressed to remain a viable supplier. Thus, this Commission has an obligation to review Frontier's broadband commitment as contained in the Settlement, and to evaluate whether the commitment will result in reasonable broadband quality and expand coverage within a reasonable time frame. In other words, if the Settlement's broadband commitment does not result in the timely deployment of high quality DSL service, it is all the more likely that Frontier will face financial straits, and as a result the Commission's policy objectives with regard to diversity of supply of voice services will be undermined.[168]

72. In sum, Frontier's business plans with regard to broadband deployment reveal a company that it is wedded to a first-generation broadband deployment model.[169] This first-generation broadband is sold by Frontier at comparatively high prices[170] and comes with usage restrictions (which Verizon does not impose).[171] Thus, Frontier's "broadband vision" has a different focus than Verizon's, and the approval of this proposed sale will produce harms to consumers resulting from the shifting to the strategic focus that characterizes Frontier's operations.

---

[168] Importantly, the fact that Frontier is likely to face deteriorating financial conditions is sufficient under the statutory requirements to reject the sale. *See supra* Section III.
[169] Roycroft, TR. 448:4-24.
[170] Weinman, TR. 281:10 – 283:6 (confirming that Verizon offers stand-alone DSL for $19.99, while Frontier charges between $29 and $35 for DSL with substantially slower upload and download speeds).
[171] McCarthy, TR. 500:6-8 (stating that the download cap "is in [Frontier's] acceptable use policy today").

C. Broadband Escrow Account.

73. The Settlement specifies that Frontier should establish a $40 million escrow account from which Frontier will be compensated as it fulfills the broadband commitments contained in the Settlement.[172] However, there are numerous critical problems with the escrow account. First, the $40 million "commitment" was made without the benefit of a capital budget for Frontier's operations in Washington. Moreover, the existence of shared facilities makes tracking broadband expenditures more difficult.[173] As a result of these factors, the $40 million commitment overlooks the larger issue of Frontier's overall level of capital spending in the state, which can impact both broadband and basic voice services.

74. Second, the Settlement does not account for Frontier's potential to gain federal broadband stimulus funding in Washington.[174] Thus, the Settlement establishes a framework that sets unreasonably low objectives for Frontier. Should Frontier receive broadband stimulus funds for Washington, under the terms of the Settlement, there is nothing to prevent Frontier from seeking reimbursement from the escrow account for broadband expenditures that will have been paid for from stimulus funds. In other words, the Settlement misses an opportunity to gain commitments from Frontier to aggressively pursue federal stimulus funding for projects in Washington that could result in a higher level of capital expenditures on broadband and the potential for more comprehensive broadband coverage and/or higher quality broadband deployment.[175]

---

[172] Exh. No. 2HC, Attachment 1 ¶ 13.
[173] Roycroft, TR. 452:12-18.
[174] *Id.* at 452:19 – 453:10.
[175] *Id.*

75. Finally, the fund is stretched-out over a five-year period and does not present a reasonable sharing of synergies.[176] Frontier has publicly stated that it anticipates synergies of $500 million per-year nationally.[177] Using access lines as a means to associate these synergies with Frontier's Washington operations, it is reasonable to apportion about $41 million *per-year* with Washington operations.[178] By the end of 2013, it is reasonable to allocate $89 million in synergies to Washington,[179] and by the end of 2014, that amount would rise to $130 million.[180] The $40 million escrow fund only accounts for 30 percent of Washington-allocated synergies that Frontier says will result from the sale. This is an inadequate commitment, leaving synergies that are reasonably associated with Washington to flow to investments in other jurisdictions, or to Frontier's shareholders.[181] Moreover, flowing synergies to Washington to be used to deploy high-quality broadband in an expeditious fashion would also be a "win" for Frontier.[182]

D. Retail Service Quality.

76. Allowing Frontier's service quality performance to deteriorate compared to Verizon's current performance level would result in harm to Washington ratepayers, yet the Settlement would allow just that. Moreover, the standards and potential penalties in the Settlement do not reflect Frontier's purported commitment to "improve" service quality should the sale be approved.[183]

---

[176] *Id.* at 454:1-455:10.
[177] Exh. No. DM-7, p. 52.
[178] Roycroft, TR. 454:15-17.
[179] Exh. No. TRR-1T, p. 101:2-5 (Roycroft Direct).
[180] *Id.*
[181] *Id.* at 455:1-6.
[182] *Id.* at 454:22-23.
[183] Exh. No. TM-1T, pp. 22-23 (McCallion Direct); Exh. No. DM-1T, p. 19 (McCarthy Direct). *See also* Exh. No. KMR-1T, p. 30:2-7 (Russell Direct).

77. The Settlement's performance standards and benchmarks are flawed for a number of reasons.[184] First, these provisions do not adequately address those areas of service where Verizon's and Frontier's historical performance show reason for concern and improvement, specifically timely repairs and installations.[185] Furthermore, the proposed standards do not include any system-wide performance level standards related to keeping installation and repair appointments, and rely entirely on a per-customer credit system to respond to this performance.[186] The lack of any such standards means that Frontier could pay out a growing level of individual customer credits and not be held accountable to system-wide degradation of service. Finally, where Verizon's performance exceeds minimum standards, the Settlement would allow service quality to *deteriorate* without any financial consequences to Frontier.[187]

78. The Settlement also lacks adequate financial incentives for compliance. The amounts set forth in Conditions 19 and 20 are unlikely to have any significant incentive on Frontier to prevent an increase in the incidences that are covered by the Settlement terms.[188] Moreover, they are miniscule when compared with what Frontier's revenues for Washington State are likely to be.[189] The additional credit that Frontier agrees to provide in Condition 19—$5 for service outages that last more than two days—is woefully insufficient as an incentive for the company. Staff has

---

[184] Exh. No. 2HC, Attachment 1 ¶¶ 19-21.
[185] Staff noted that these areas were of greatest concern when considering Verizon's historic performance in Washington and data regarding Frontier's performance in other states. Exh. No. KMR-1T, pp. 20: 8-9 and 23:19-20 (Russell Direct). For example, Verizon's performance with respect to installation appointments in particular has deteriorated significantly in recent years. *See* Exh. No. BRA-3C.
[186] *See* Exh. No. 2HC, Attachment 1 ¶ 19.
[187] Alexander, TR. 406:12-17. *See also* McCarthy, TR. 251:20-24. Indeed, the Settlement sets no new standards and instead only requires Frontier to comply with the Commission's service quality rules and Verizon's current tariffs, but things that Frontier would arguably be required to do absent any settlement. *See* Alexander, TR. 407:1-7. Moreover, the conditions laid out in the FEA Settlement are no more than reporting requirements; while Frontier should be required to file reports regarding service, these provisions create no actual incentive or mechanism for addressing service quality failures. *See* Alexander, TR. 404:7 – 405:20.
[188] Alexander, TR. 408:9-19.
[189] *See* Exh. No. DM-21C (Verizon WA's intrastate jurisdictional revenues as reported to the FCC in 2008).

estimated that if this credit had been in effect in 2008, Verizon would have paid **[Begin Highly Confidential]** XXXX **[End Highly Confidential]** to affected customers.[190] Thus, this amount is unlikely to provide an incentive for Frontier to ensure that long service outages do not occur. Also, this dollar amount is not related to the length of the customer's outage so that a customer who is without service for much longer than 48 hours is not recompensed commensurate with the outage.

79. The proposed dollar amounts that would be imposed on Frontier if it fails to meet the generous annual performance standards in Condition 20 are insignificant compared to historical annual revenues associated with the jurisdictional services provided by Verizon in Washington.[191] Frontier could violate each of these six metrics and suffer a "penalty" of $600,000 in the first year.[192] Even if Frontier fails to meet all six standards for two out of three years, the total penalty would only be doubled to $1.2 million.[193] If Frontier fails to meet the standards for all three years, the total maximum penalty would be $1.8 million.[194] These amounts are also just a fraction of what Public Counsel and Staff previously determined would be appropriate—Public Counsel recommended a potentially maximum annual penalty of $9.5 million, representing **[Begin Highly Confidential]** XXXXXX **[End Highly Confidential]** of Verizon-WA's 2008 annual retail jurisdictional revenues[195] while Staff had recommended a maximum annual penalty

---

[190] *See* Exh. No. WHW-33. The Joint Applicants confirmed Staff's estimate. Exh. No. BJG-39.
[191] *See* Exh. No. DM-21C. While it is important to incent companies to provide adequate service, it must also be noted that penalties lose their utility when imposed on a company that is financially unable to comply. *See PSE Sale,* ¶ 115 (stating that the Commission evaluates "the commitments made in the transaction are enforceable."). *See also* Exh. No. SGH-28, p. 33 (stating, "penalties cannot cause compliance if the provider is financially unable to comply").
[192] Weinman, TR. 308: 17-22.
[193] McCarthy,TR. 387: 9-23.
[194] *Id.*
[195] Exh. No. BRA-1CT, p. 41:17 – 42:2 (Alexander Direct).

at risk for service quality violations of $5 million.[196]

E. Retail Service Rates and Terms.

80. The Settlement does not provide adequate protections against the very real risks that the terms and rates for retail service would be negatively impacted by the proposed sale.

1. The Settlement does not adequately protect against increases in rates and pricing for retail phone, DSL, and bundled services.

81. Despite its three-year rate cap for flat and measured-rate residential service, [197] the Settlement does not offer reasonable price protection for other services, including bundles. The Settlement provides that Frontier will offer the same bundled services as Verizon, at the same rates, for one year after closing.[198] However, as Mr. Weinman conceded during cross-examination, the Settlement does *not* offer protection against increasing rates after twelve months.[199] This amounts to additional risk for Washington ratepayers, as the record shows that Frontier pursues retail pricing strategies that are characterized by DSL prices between 25 and 67 percent higher than Verizon's.[200]

82. Likewise, while the Settlement requires Frontier to offer stand-alone DSL at Verizon rates for 12 months, it does not directly address other DSL pricing issues.[201] As mentioned above, Frontier charges substantially higher rates than Verizon for DSL service, as well as potentially

---

[196] Exh. No. KMR-1T, pp. 26:15 – 27:1 (Russell Direct). As noted by Commissioner Oshie at hearing, the proposed dollar amounts also stand in stark contrast to the $20 million in potential penalties approved by this Commission in the recent Qwest docket. TR. 341:11-12 (referring to *In Re Application of U S West, Inc., And Qwest Communications International, Inc., For An Order Disclaiming Jurisdiction, or in the Alternative, Approving the Merger*, Docket No. UT-991358, Ninth Supplemental Order, ¶ 61).
[197] Exh. No. 2HC, Attachment 1 ¶ 23.
[198] *Id.* at ¶ 26.
[199] Weinman, TR. 287:20-288:5.
[200] *See* Exh. No. TRR-1HCT, p. 50:1-4 (Roycroft Direct). Staff reached this same conclusion initially. Exh. No. JYR-1HCT, pp. 12:15– 13:11 (Roth Direct).
[201] Roycroft, TR. 459:21-22.

higher early termination fees.[202] However, the Settlement does *nothing* to address the harm that will be inflicted on Verizon customers who would likely face rising DSL prices should Frontier take over operations in this state.

2. The Settlement does not address Frontier's restrictive broadband use policies.

83. Verizon's current DSL customers are able to take advantage of "all-you-can-eat" pricing[203] while Frontier imposes a download cap that identifies an upper limit to the amount of data that a customer can download without the threat of action by Frontier.[204] Frontier's download cap represents a very real harm for customers who may be transferred to Frontier because it hampers the utility of broadband internet access. The Settlement is silent on this issue.[205] At hearing, Mr. McCarthy stated that Frontier intends to modify its acceptable use policy to eliminate the download cap.[206] However as of February 23, 2010, Frontier's acceptable use policy remains unchanged, *i.e,*. the download cap remains in place.[207]

3. Provisions related to the PIC charge do not apply to contracts for other services.

84. The Settlement provides that Verizon customers must be given the opportunity to change long-distance carriers without incurring a PIC charge. While this provision is appropriate, it does not go far enough.[208] Customers who may have a choice of providers for other services should also have the ability to re-evaluate their relationship with Frontier following the closing

---

[202] Exh. No. TRR-1HCT, pp. 71:13 – 72:3 (Roycroft Direct).
[203] Roycroft, TR. 460:13-15.
[204] Exh. No. TRR-1HCT, pp. 72:4-73:11(Roycroft Direct).
[205] Roycroft, TR. 461:4-8.
[206] McCarthy, TR. 500:11-15.
[207] Residential Internet Acceptable Use Policy, http://www.frontier.com/policies/residential_aup/ (last visited February 23, 2010).
[208] Roycroft, TR. 462:1-18.

without penalty, in other words be allowed a "fresh look" at existing contracts.[209] A "fresh look" is necessary to protect against the harm of forcing customers who entered into term contracts with Verizon, not Frontier, from being forced into contracts with a service provider that they did not chose.

F. Operations Support Systems.

85. The Joint Applicants propose that Frontier utilize a "replicated" version of Verizon's operating systems immediately after the sale.[210] Frontier will then be free to integrate those operations into its legacy systems at any time.[211] Both of these operational stages present very real risks that the Settlement does not adequately address.

1. The proposed cut-over to the replicated systems presents numerous risks that the Settlement does not address.

86. The provisions of the Settlement regarding the cut-over to replicated systems do not sufficiently address the concerns previously expressed by both Staff and Public Counsel.[212] First, the Settlement only requires that replicated systems operate for 60 days before closing and thus does not create the opportunity for a detailed evaluation of the operations of the replicated systems.[213] Staff testified previously that that 60 days' worth of data would not be sufficient for such evaluation, and that the replicated systems should operate for at least 90 days prior to closing for proper review.[214] Staff has not presented, nor does the record contain, any evidence as to why the shorter period is now sufficient. Moreover, at hearing, Staff confirmed that service

---

[209] *Id.*
[210] Exh. No. DM-1T, p. 50:12-15 (McCarthy Direct).
[211] *Id.* at p. 51:11-12.
[212] Exh. No. 2HC, Attachment 1 ¶ 28.
[213] Roycroft, TR. 463:2 – 464:8.
[214] Exh. No. RTW-1HCT, p. 19:9-13 (Williamson Direct).

quality varies greatly from month-to-month[215] and that, at least in the area of billing errors, 60 days would only allow evaluation of one billing cycle.[216]

87. Second, rather than identifying specific performance metrics that must be satisfied, the Settlement uses vague terminology to describe the outcome of the production mode. Condition 28 provides:

> The reports must show that by the end of the production mode, there has been no material (i.e., of substantial import) degradation from benchmark quality of service data from 12 months prior to production mode on the replicated systems...[217]

Thus, under the terms of the Settlement, the sale can close even if the service quality reports show *degradation* from benchmark performance levels.[218] Furthermore, the benchmarks are tied to Verizon's performance over the last 12 months, which represents a period where Verizon service quality performance has *already declined.*[219]

88. Additionally, the Settlement provisions describe a very limited role for the third-party reviewer.[220] Condition 27 indicates that the results of pre-production tests on retail customer-affecting systems need only show that "severity level 1" failures (full service denials) have been resolved as verified by a third party reviewer. However, other than the condition for "full service failures," the Settlement does not specify any other performance benchmarks associated with the pre-production tests. "Severity level 2" failures are not addressed in the Settlement. A "severity

---

[215] Weinman, TR. 289:11-14.
[216] Williamson, TR. 296:22 – 297:10 (stating, "[b]illing is a difficult one to do, I believe we'll see 1 full billing cycle in that 60 day period where a customer has a chance to look at their bill, and if they have an issue it is usually 3, 4, 5, 10 days before they will call, so we'll probably really only see complaints from 1 billing cycle . . . we would be happy of course to have six months to look at data before we said it was okay").
[217] Exh. No. 2HC, Attachment 1 ¶ 28.
[218] Notably, the allowed level of degradation is not defined. *See* Williamson, TR. 297:25 – 298:2.
[219] Roycroft, TR. 464:9-19.
[220] *Id.* at 463:16-18.

level 2" failure exists where computer code issues may affect business processes, but have been addressed with a "workaround" to negate the negative impact. Understanding the extent of these "workarounds" would contribute to an understanding how robust the replicated systems are likely to be, but will not be examined by the third-party reviewer.[221]

89. Finally, the Settlement does not provide the Commission any authority to delay the closing or to order service quality improvements if serious service quality problems arise.[222] Moreover, Staff is given only five days to review this data.[223] It seems impractical, if not impossible, to expect that within just five days, Staff will be able to review sixty days' of reports and take the necessary action to identify and ensure that any problems or errors in the replicated systems, or resulting service degradation, and ensure they are addressed.

2. Future integrations.

90. Condition 29 of the Settlement requires Frontier to notify Staff of any plans for integrating the replicated systems into its legacy systems within three years of closing. In addition, Frontier has provided no information regarding past integrations or its potential outline for integrations in Washington.[224] Frontier has also not identified when such integrations will occur and has repeatedly stated that it will be in no rush to cut over, pointing to the Rochester transaction in which it did not cut over for over seven years, as well as previous Verizon integrations that did not occur for nine years.[225] Thus, as Dr. Roycroft testified at hearing, the three-year duration of this provision is inadequate.[226] Thus, this Settlement provision does not

[221] *Id.* at 464:1-4.
[222] Williamson, TR. 298:3-6; Weinman, TR. 300:7 – 301:4.
[223] Williamson, TR. 296:11-12.
[224] *Id.* at 320:1-13.
[225] *See supra* n. 142.
[226] Roycroft, TR. 465:11-19.

adequately protect against harms that are likely to arise during such integrations because there is no assurance that the Commission will be notified of such integrations, or have the authority to review or condition such actions.

VI. ALTERNATIVE RECOMMENDATIONS OF PUBLIC COUNSEL

91. Although Public Counsel's primary recommendation is that the proposed sale be rejected, the following additional conditions, discussed in light of the conditions in the Staff and FEA settlements, would move the sale towards meeting the standards for Commission approval.[227]

A. Debt Financing.

92. Given the timing of the debt financing, the Commission will not know the cost at which Frontier secures the $3.3 billion debt necessary to consummate the proposed sale until March or April of 2010.[228] Ensuring that Frontier does not undertake too costly of debt is necessary to ensure that it remains a financially operable service provider. Thus, as a preliminary requirement, the Commission should condition its approval upon a showing that Frontier has not financed the new debt at a rate above 9.5 percent.[229] As soon as Frontier secures this debt, it should file a report with the Commission summarizing the details of that financing, along with all the pertinent documentation and agreements. If Frontier fails to provide adequate documentation and assurance that the $3.3 billion debt was financed at a rate at or below 9.5 percent, the Commission's approval should be withdrawn.

/ /

/ / /

---

[227] *See supra* Section III.

[228] *See supra* Section II.C.

[229] Public Counsel made this recommendation in its direct testimony. *See* Exh. No. TRR-1HCT, p. 91:3-11 (Roycroft Direct). In addition, in entering the Settlement, Staff accepted that Frontier could retain strong cash flows up to a rate of 9.5 percent. *See* Exh. No. WHW-14T, p. 5:1-6 (Weinman Supporting).

B. Regulatory Claw-Back.

93. The existence of a regulatory "claw back" prohibition is a central concern in this case. According to the Merger Agreement, if regulators require any sort of monetary contribution by Verizon, *e.g.*, a lower sale price for the assets or any outright contribution by Verizon, Frontier would have to pay the originally agreed upon value for the SpinCo assets *plus* the value of any regulatory "claw back."[230] This functionally prohibits the Commission from requiring a monetary contribution by Verizon to mitigate the risks associated with Frontier's financial capability, because doing so would ultimately place further financial burden on Frontier.[231] In addition, the "claw back" prohibition means regulators cannot require Verizon to ensure the condition of plant, service quality, or adherence to broadband commitments, without simultaneously weakening Frontier financially.

94. The "claw back" prohibition set out in the Merger Agreement is unacceptable as a matter of law—the Commission's jurisdiction and authority cannot be limited by the terms of the Merger Agreement. Just as parties to a court proceeding cannot contractually remove a court's jurisdiction over a matter,[232] parties to a regulatory proceeding before a state commission cannot limit the commission's jurisdiction through a private contract.[233] Here, the "claw back"

---

[230] Agreement and Plan of Merger Dated as of May 13, 2009 By and Among Verizon Communications Inc., New Communications Holdings Inc. and Frontier Communications Corporation (filed May 29, 2009), §§ 1.167 and 1.144.
[231] *See* Exh. No. DM/TM-1T, p. 14:2-3 (McCarthy/McCallion Supporting). *See also* McCallion, TR. 364:16-22.
[232] *See, e.g.*, 20 Am Jur 2d Courts § 96 ("jurisdiction of the courts cannot...be ousted" by a private party agreement); *see also* Rest. 2d Confl. § 80 (individuals lack power to "alter the rules of judicial jurisdiction" and may "not by their contract oust a state of any jurisdiction it would otherwise possess").
[233] *See, e.g., Joint Petition of Iberdrola, S.A., Energy East Corp., RGS Energy Group, Inc., Green Acquisition Capital, Inc., New York State Electric & Gas Corp. and Rochester Gas and Acquisition Capital, Inc., New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation for Approval of the Acquisition of Energy East Corporation by Iberdrola, S.A*, Docket 07-M-0906 (New York Public Service Commission, Feb. 19, 2008) (rejecting deference to third party agreement because agreement would "oust the Commission from its jurisdiction by operation of a private contract, a result plainly irreconcilable with the Commission's plenary regulatory authority" and noting that "conflict between [third party] agreements and the Commission's exercise of its statutory authority must be resolved in favor of the latter").

prohibition would operate to limit the Commission's authority to review proposed divestitures.[234] The Commission is statutorily required to ensure the proposed sale is in the public interest,[235] and its review consists of an analysis of several factors, including the financial capability of Frontier.[236] The enforcement of the "claw back" prohibition would directly undermine the Commission's duty to conduct this review and ensure the financial capability of the proposed buyer. By freeing Verizon of any regulator-imposed costs and contractually forcing these costs onto the already weak Frontier, the provision effectively seeks to prevent the Commission from imposing any monetary conditions upon Verizon, even if those conditions are necessary to ensure that the sale is in the public interest. Accordingly, the inclusion of a "claw back" prohibition in the Merger Agreement should not limit the Commission's jurisdiction—the Commission is free to condition its approval of the sale on monetary contributions by Verizon which, regardless of this provision, Verizon must accept to receive Commission approval, without seeking repayment.

95. There are several approaches that the Commission may take to require a monetary contribution from Verizon. The Commission may require that the parties accept as a condition of approval that certain amounts not be defined as "Required Payment Amount[s]" as defined in the Merger Agreement, and thus any such payments would have no impact on the closing equity value of the SpinCo properties.[237] Indeed, it appears that Staff and the Joint Applicants took this

---

[234] RCW 80.12.020.
[235] WAC 480-143-170.
[236] *Verizon-MCI*, Order No. 7, ¶ 59.
[237] The Merger Agreement defines "required payment amounts" in § 1.144 as:

> [T]he aggregate amount, if any, of all amounts required to be paid, refunded, deferred, escrowed, or forgone pursuant to an order, settlement agreement or otherwise…by Verizon or its Subsidiaries, other than post-Closing obligations of SpinCo or any SpinCo Subsidiary, as a condition to obtaining any consent of any governmental Authority in the Territory required to consummate the Distribution or the Merger or to complying with any order approving the Distribution and the Merger.

very approach in Condition 27 of the Settlement, which assigns the cost of the third party verifier of replicated operating systems test results to Verizon.[238] Alternatively, the Commission may require, as a condition of its approval, that the certain amounts be paid by Verizon without reimbursement from Frontier; the Joint Applicants would then be free to modify the Merger Agreement to the extent necessary to fulfill such a condition.

C. Financial Conditions.

96. As the record shows, Frontier is financially weaker than Verizon, presenting very real risks for Washington ratepayers. Moreover, the financial modeling and projections used to set the purchase price and predict Frontier's future revenues appear to be unrealistically optimistic and cannot be tested. If the Commission approves the proposed sale, it should impose the following financial conditions in addition to those contained in the Settlement.

1. Monetary contribution from Verizon.

97. Any approval of the proposed sale must be conditioned upon a monetary contribution from Verizon. The proposed settlements include no such provisions. As discussed previously, it is likely that the purchase price is too high and paying such an amount may leave Frontier financially unable to continue operations in Washington, or meet the commitments it has made here or in other states.[239] Moreover, a contribution by Verizon is necessary to address the risks associated with Frontier's financial weaknesses and its untested revenue and expense projections.

---

[238] Exh. No. DM/TM-1T, p. 13:11-14 (McCarthy/McCallion Supporting) ("Verizon is obligated to pay for the retention of an independent third-party 'reviewer'"). *See also* Weinman, TR. 374:16-24 (stating, when asked whether Staff was concerned whether any of the new settlement conditions would create costs that would be passed onto Frontier, "our biggest concern was having a third party verify the IT systems. And since Verizon – that cost won't be passed along to Frontier, and other than that my answer is no").

[239] *See supra* Section IV.B.

98. Accordingly, if the Commission approves the proposed sale, it should require Verizon to contribute at least $600 million to Frontier to reflect an adjustment to the purchase price.[240] Such a requirement could be imposed either through a cash transfer from Verizon to Frontier or by a $600 million reduction in the $3.3 billion cash transfer currently planned from SpinCo to Verizon prior to the sale. Because Washington represents approximately 12 percent of the SpinCo properties (based on its share of total access lines), the application of this condition in Washington should result in $72.4 million flowing to Frontier's Washington operations. As described by Mr. Hill at hearing, these monies could be directed towards capital expenditures in Washington, but serve the primary purpose of adjusting the valuation of the proposed sale.[241]

2. Monetary guarantee by Verizon.

99. Frontier has not performed any objective, supportable due diligence of Verizon's physical plant in Washington and thus its projections regarding necessary capital expenditures are unsupported and unreliable.[242] In fact, the record shows that Verizon's outside plant may require substantial additional investment.[243] Therefore, should the Commission approve the proposed sale, it must require Verizon to provide a monetary guarantee of the condition of the Washington plant. Verizon should establish a $40 million fund, structured as an interest-bearing escrow account, to insure the condition of its outside plant in Washington.[244] This fund would provide money to remedy problems with Verizon's outside plant so that service quality can be maintained and DSL can be deployed in a timely manner.[245] Verizon should also be given the

---

[240] Public Counsel previously provided the bases for this amount. *See* Exh. No. SGH-1HCT, p. 50:6-14 (Hill Direct).
[241] Hill, TR. 630:9 – 631:13, 654:8-13, and 660:8 – 661:1.
[242] McCarthy, TR. 348:6-10 (stating that Frontier relied entirely on data from Verizon during the process of diligence); *see also* Roycroft, TR. 677:17 – 678:678.
[243] *See supra* Section IV.C.2.
[244] *See* Exh. No. TRR-1HCT, p. 94:12 – 95:6 and 96:8 – 97:2 (providing bases for this amount) (Roycroft Direct).
[245] *See id* at pp. 96:8 – 97:2. *See also* Roycroft, TR. 670:20 – 671:6.

opportunity to demonstrate that the size of the fund ought to be adjusted. If Verizon chooses, it should be allowed to sponsor an audit of its outside plant.[246] If the audit shows that the plant does not require such costly repairs, the size of the fund could be decreased. However, if the audit discovers problems with the plant that have the potential to impair service quality or impede DSL deployment, such problems should be remedied at Verizon's expense.

3. Limitations on Frontier dividends or cash payments.

100. If, following the proposed sale, Frontier continues to pay dividends that exceed earnings, its financial position will further deteriorate.[247] That is, no matter what the post-sale common equity ratio winds up being, continuing to pay out dividends that exceed earnings will reduce common equity over time and weaken the financial structure of Frontier. Thus, Frontier NW, the operating company, should be prohibited from paying the parent company, Frontier, Inc., dividends in excess of earnings.[248] Notably, Frontier agreed to a potential dividend limitation in its settlement with parties in Illinois.[249] Because a prohibition on dividend payments is designed to retain monies in the local service area, it is important that the Frontier be required to provide the financial statements to show that it complied with the requirement and to track the monies not paid out as dividends to Frontier, Inc.

---

[246] An audit process would also allow the Commission to gain further information regarding condition of Verizon's outside plant.

[247] Exh. No. SGH-1HCT, p. 52:7-9 (Hill Direct).

[248] At hearing, Frontier confirmed that the operating company, Frontier NW, will be a separate corporation with its own books of account, headquartered in Washington. *See* McCarthy, TR 254:12 – 255:6. This would make imposing a dividend restriction possible. However, Public Counsel recognizes that there may be practical shortcomings of imposing a dividend restriction on Frontier NW for the purpose of retaining cash at the operating company, and thus provides an alternative approach.

[249] *See* Exh. No. DM-75, p. 2:215-219 (accepting, with minor revisions, Illinois Staff's recommendation that if Frontier failed to meet a certain amount of service quality metrics in a given year, the "Illinois operating companies would be restricted from paying dividends or otherwise transferring cash balances to the corporate parent, Frontier, for the following year") (McCarthy Surrebuttal before the Illinois Commerce Commission).

101. There may be alternative means of retaining funds in the operating company.[250] For example, the Commission could enhance the proposed intercompany payables reporting requirement to include a baseline and limit for intercompany payables and receivables.[251] Since it cannot currently be determined, the appropriate level for such a baseline would have to be set by looking at Verizon's historical ratio of cash flows.[252] Thus, if historically the cash flows from Verizon NW (the operating company) to Verizon (the parent) were 2.5 times the cash flows moving from Verizon to Verizon NW, then cash flow payments between Frontier NW and Frontier, Inc. should be limited to a similar ratio. If Frontier's ratio rose so that considerably more cash was being transferred out of Frontier NW than was the case with Verizon NW, regulatory penalties or some other incentive mechanism should be applied to bring the cash flows back in line with baseline requirements.[253]

4. AFOR application and earnings review filing requirements.

102. There is no reason to "require" an AFOR filing as a condition of the proposed sale. As previously discussed, an AFOR is a "lighter" form of regulation that would be favored by any regulated firm, including Frontier, and Frontier is not limited from applying for an AFOR at any time. Moreover, requiring an AFOR will actually increase, rather than mitigate, the risks that the

---

[250] Public Counsel presents this alternative in response to concerns raised regarding the utility of dividend restrictions on a telecommunications firm. *See* Exh. No. WHW-1T, p. 17:14-21 (Weinman Direct).
[251] Exh. No. 2HC, Attachment 1 ¶ 1.
[252] For example, if Verizon's previous ratio of cash flows from Verizon NW to the parent compared to those from the parent to Verizon NW was 3.0, Frontier's post-sale cash flow ratio could similarly be restricted to 3.0 or lower.
[253] Frontier has agreed to a potential prohibition on operating-company-to-parent cash flows in settlements with parties in Illinois. *See supra* n. 249. In addition, Staff indicated at hearing that it believes the Commission will ultimately regulate cash flows between the operating and parent companies in any case. *See* Weinman, TR. 327:13-24 (stating, "watching chose cash flows on a quarterly basis gives us some sense of [whether the] parent [is] just trying to suck too much cash out of the operating company for whatever purpose . . . we have our eyeballs on it and are able to make some judgment. And if we need to come before the Commission, I assume there's some mechanism that will allow us to do that"); *see also* Weinman, TR. 329:9-17.

proposed sale presents for ratepayers because, as confirmed by Staff, regulatory flexibility almost always leads to increased rates.

103. The earnings review suggested in the Settlement provides inadequate procedural protections for ratepayers as compared to the procedures provided under a full rate case. Thus, if the Commission requires an earnings review (whether as part of an AFOR or separately), it is appropriate that it do so in a general rate proceeding *after* sufficient time to ensure that any synergies have been realized and thus can be properly reflected.

D. Additional Conditions.

104. Public Counsel proposes the following additional conditions, which are further discussed in its direct testimony.

- **DSL/Broadband.** Should the Commission approve the proposed sale, it should require Frontier to make broadband services available in 100 percent of its wire centers, and to 90 percent of its Washington customers, by the end of 2013.[254] Frontier should expand broadband availability to 100 percent of its customers by 2015.[255] Moreover, Frontier should deploy and promote broadband services so that, by the end of 2013, at least 90 percent of its customers can achieve download speeds of 3 Mbps; 75 percent of its customers can achieve download speeds of 6 Mbps; and 50 percent of customers can achieve download speeds of 10 Mbps.[256]

  To achieve these broadband objectives, Frontier should commit to exceed Verizon's baseline level of capital investment by at least $49 million (or by an amount sufficient to meet the broadband objectives) over and above the $40 million escrow during the period ending December 31, 2013.[257] In addition, the stand-alone DSL commitments (terms and rates) should be extended for at least

---

[254] *See* Exh. No. TRR-1HCT, pp. 98:21 – 99:15 (Roycroft Direct).
[255] *Id.* at p. 99 n. 193..
[256] *Id.* at pp. 98:21 – 99:15. Notably, it appears that Staff believes 100 percent deployment is appropriate. In testimony supporting the settlement, Mr. Weinman stated that Staff would rely on the FCC to mandate deployment above the levels specified in the settlement. *See* WHW-14T, p. 9:6-21 (Weinman Supporting).

The Commission may require reports to ensure that Frontier develops a reasonable plan for deployment and regular progress towards meeting these requirements. Such a plan is described in the direct testimony of Public Counsel witness, Dr. Roycroft. *See* Exh. No. TRR-1HCT, pp. 99:3 – 100:2 (plan) and 101:20 – 102:2 (progress reports) (Roycroft Direct).
[257] Exh. No. TRR-1HCT, pp. 98:21 – 102:2 (Roycroft Direct).

two years after close,[258] and Frontier should be ordered to eliminate the download cap that currently appears in its Acceptable Use Policy.[259]

- **Operations Support Systems.** The third-party reviewer should report on all issues that could potentially affect the operations and efficacy of the replicated systems and not be limited to reporting on "severity level 1" failures. Furthermore, the Commission itself ought to have the authority to approve the selection of the third party that will oversee the testing of the replicated systems and approve a testing plan that will enable the Commission to directly obtain information on every aspect of the accuracy of the replicated systems for billing, customer service, operation of 911 systems, wholesale operational systems, and the customer call center.

  In addition, Verizon should face penalties if its replicated systems fail to perform as represented in the Merger Agreement. The penalties for Washington should be set at $7.7 million per year as described in the pre-filed testimony of Dr. Roycroft.[260] Such a penalty is appropriate due to the lack of sufficient incentives for Verizon to ensure that the replicated systems function appropriately,[261] and in light of the fact that It Verizon, not Staff, is in the best position to ensure the operability of the replicated systems and should, as seller, be responsible for their operability.[262]

- **Future Integrations.** The Commission should modify Condition 29 to provide an open-ended requirement for notification, *i.e.* the requirement for Commission reports should not be limited to three years. The Settlement requirement that Frontier file a plan with the Commission prior to any integration should be amended to require quarterly reports on the integration of business and repair office operations and billing systems.[263] These reports would keep the Commission apprised of additional integration steps Frontier may take and could allow it to intervene should problems, such as those experienced by FairPoint, occur. In addition, the proposed condition requiring reporting on consolidation of network operations and staffing levels should not terminate after three years and instead should remain in place until any future integrations have occurred.

- **Retail Service Quality.** The following amendments to the Settlement should thus be made. Paragraph 19 should be revised to condition any petition to eliminate these additional customer credits based on Frontier's performance, which should demonstrate that it has reversed the recent deterioration in missed appointments

---

[258] *Id.* at p. 102:8-12.
[259] Frontier indicated that it was in the process of eliminating this cap currently. *See* McCarthy, TR. 500:6-15.
[260] Exh. No. TRR-1HCT, p. 95:7-23 (Roycroft Direct).
[261] *See* Exh. No. 2HC, Attachment 1 ¶ 28.
[262] Staff is given only five days to review the report on the functionality of the replicated systems and has full responsibility for taking remedial action should there be any shortcomings. *Id.*
[263] *Id.* at ¶ 29.

by Verizon and prevented any increase in the level of such missed appointments. The $5 credit for an outage in excess of 48 hours should be revised to adopt a higher credit amount for lengthier outages.

The performance standards in Condition 20 should be revised to ensure that the standards reflect actual performance that is better than the Commission's minimum standards.[264] The dollar amount of penalties should be significantly increased to $9.2 million as recommended by Public Counsel in its direct testimony, approximately equal to **[Begin Highly Confidential]** XXXXXX **[End Highly Confidential]** of revenues.[265] Finally, Condition 20 should remain in effect until Frontier has demonstrated compliance with these minimum provisions for three years or the completion of its integration of Washington's operations into Frontier's legacy systems, whichever comes last.

- **Archive of Customer Data.** Verizon should create an archive of customer records that will be maintained for 12 months following the closing.[266] This archive should be available to Frontier, and its customers, to verify data that is transferred to Frontier.

- **Retail Service Rates.** Currently, the Settlement indicates that Frontier will maintain Verizon's current bundle[267] and stand-alone DSL rates[268] for twelve months. As discussed previously, these pricing commitments are inadequate to protect Washington ratepayers from paying for any increased costs resulting from Frontier's management of Verizon's Washington operations.[269] To effectively hold the Joint Applicants to their commitment not to pass increased costs onto retail customers, Frontier should be required to maintain bundled service offerings at their current terms and rates for two years. Moreover, Frontier confirmed at hearing that it had "no plans to discontinue the bundles whatsoever."[270] As discussed below, customers in term contracts with Verizon should be given the opportunity to opt out of such contracts since not allowing them to do so would force them into contracts with Frontier, a provider they did not select.

- **Fresh Look.** Frontier should, in addition to providing waiver of PIC charges, allow residential customers a "fresh look" at existing retail contracts, thereby ensuring that customers bound by a term agreement may end that agreement without penalty. The period for "fresh looks" should begin at the date when

[264] *See* Exh. No. BRA-1HCT, pp. 33:15 – 35:1 (providing metrics and standards) (Alexander Direct).
[265] *Id.* at pp. 41:17 – 42:2.
[266] Exh. No. TRR-1HCT, p. 93:27-30 (Roycroft Direct).
[267] Weinman, TR. 287:6-9.
[268] *Id.* at 280:18-21.
[269] *See supra* Section V.E.1.
[270] McCarthy, TR. 385:10-11.

Frontier takes possession of Verizon's operations and extend for a period of 90 days.[271]

- **Customer Notice.** Frontier should provide individual written notice to customers regarding the sale, including an explanation of any change in services that may result. Individual customer notice is necessary to ensure customers are fully aware of service changes and options they may have.[272] In addition, Changes in billing format should also be clearly explained to customers in writing and through a web-based tutorial. A clear explanation of changes in billing format is necessary to reduce customer confusion.

VII. PUBLIC COMMENT

105. Seven witnesses addressed the Commission at hearings on October 15, 2009 in Everett. Among those testifying at the Public Hearing were several Verizon employees who offered direct knowledge of the actual physical condition of Verizon's plant that is not detailed anywhere else in the record in this proceeding. One of those employees, Mr. Joseph Loo, testified regarding his concern about the condition of Verizon's plant and what will be required of Frontier if it takes over:

> But as an employee, since Verizon has taken over, our plant has deteriorated, and Frontier is planning to move in and supply DSL to far reaching places, which Verizon was supposed to do, and I don't know how they're going to do that with the plant that we have presently...[a]nd I hear from other employees that our cables are in such bad condition it takes two pairs to make dial tone. It also takes that same two pairs to get that DSL out to the customers. When those pairs go bad, you got to move them or repair them. We used to have maintenance people, which I was one. They made us stop repairing and continue on with customer service. But how do you do that when the plant facilities are so bad that you can't make repairs, that you're stealing from other places in the cable to try to get these customers back in service . . . . [T]he money that they're going to have to put into the plant is going to be enormous.[273]

---

[271] Public Counsel made this recommendation previously in its direct testimony. *See* Exh. No. TRR-1HCT, p. 104:20-23 (Roycroft Direct).
[272] The Commission recently approved a settlement term requiring individual written customer notification of company name change. *See CenturyTel*, Order No. 05, ¶ 36.
[273] TR. 61:18-62:20; 63:7-8.

106. Mr. Steve Walcker, another Verizon employee and customer discussed his similar concern about the condition of the physical plant, as well as Frontier's vision for its services:

> I've been a consumer for 20 years with this company, previously GTE and now Verizon, and I do like parts of Verizon...They are very forward thinking. I like their choice of FiOS. As an employee, I have seen the deterioration of the cable plant. . . . I don't care for the technology that Frontier is about to take on, the DSL technology. I don't believe that it can compete in the marketplace...will it sell when the competitor is putting out 16 and 22 meg and on the other hand Frontier does around 8 meg?[274]

107. A total of 172 public comments were received by the Commission and Public Counsel. Of these, 82 oppose the proposed transaction, 48 support the transaction. Twenty-three neither oppose nor support the proposed transaction.[275]

108. Mr. Alfy Calle wrote wondering about what proposed change in ownership would mean for consumers who chose Verizon and are now tied into contacts with Verizon, who they specifically chose for their history of service.

> I just recently signed up for a 2 year contract for DSL and I am concerned about changes to as new company that is unknown to me. I am not as worried about the phone service, however, the DSL service there are less to choose from in my area. I went with Verizon because they are a well known company and have a history, I don't know this other company. [276]

109. Mr. David Kuemerle wrote following the announcement of the Settlement, expressing concern that the Settlement does not provide adequate protections against the risks of the transaction:

> Frontier has made with UTCs of various states associated with the Verizon sale involve concessions and provisions costing Frontier tens of millions of dollars. What is the plan when Frontier, which recently had their stock downgraded to unfavorable, reneges on all their concessions, promises, and provisions? Where are the current subscribers left when Frontier is not able to fulfill their end of the

---

[274] TR. 86:15-21; 87:6-11; 88:23-89:13.
[275] Exh. No. 3, p. 2.
[276] *Id.* at Attachment "UTC Comment Database Attachment Docket UT-0908742," p. 5.

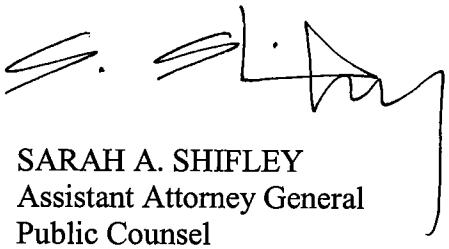
bargains and agreements? What happens to these concessions when Frontier files for bankruptcy protection, as has every other entity Verizon has sold? [277]

VIII. CONCLUSION

110. The record shows that the proposed sale of Verizon's Washington wireline operations to Frontier will result in numerous risks and harms. Neither the Joint Applicants, nor the settling parties, have provided evidence to the contrary. The proposed settlements fail to protect against the serious risks or provide benefits offsetting the identified harms. Therefore, Public Counsel must recommend that the Commission reject the proposed sale and settlements.

111. DATED this 26th day of February, 2010.

ROBERT M. McKENNA
Attorney General



SARAH A. SHIFLEY
Assistant Attorney General
Public Counsel

[277] *Id.* at Attachment "UTC Comment Database Attachment Docket UT-0908742," p. 63.