

**BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

In the Matter of the Joint Application of  
Verizon Communications Inc. and  
Frontier Communications Corporation  
For An Order Declining to Assert  
Jurisdiction Over, or, in the Alternative,  
Approving the Indirect Transfer of  
Control of Verizon Northwest Inc.

**DOCKET UT-090842**

**POST HEARING BRIEF ON BEHALF OF COMMISSION STAFF**

**February 26, 2010**

**ROBERT M. MCKENNA**  
**Attorney General**

**JONATHAN THOMPSON**  
**Assistant Attorney General**  
**Office of the Attorney General**  
**Utilities & Transportation Division**

**1400 S Evergreen Park Drive SW**  
**P.O. Box 40128**  
**Olympia, WA 98504-0128**  
**(360) 664-1225**

**REDACTED VERSION**

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## I. INTRODUCTION

1 Commission Staff provides this post-hearing brief in support of the Commission’s  
approval of the settlement agreement that Staff has negotiated with Frontier Communications  
Corporation (Frontier) and Verizon Communications Inc. (Verizon) (collectively, the “Joint  
Applicants” or “Applicants”) for the conditional approval of the transfer of control of Verizon  
Northwest Inc. (Verizon Northwest).

## II. DESCRIPTION OF THE TRANSACTION

2 Verizon Northwest is a registered telecommunications company that provides local  
exchange services in 81 exchanges in Washington. Verizon Northwest also provides local  
exchange services in parts of Oregon and Idaho. As of December 31, 2008, Verizon Northwest  
served approximately 578,000 access lines in Washington.<sup>1</sup>

3 Verizon Northwest is an indirect, wholly-owned operating subsidiary of Verizon  
Communications Inc. (“Verizon”), a publicly traded company. At the end of the first quarter of  
2009, Verizon’s telephone operating company subsidiaries collectively served approximately  
35.2 million wireline access lines in 25 states and the District of Columbia.<sup>2</sup>

4 Frontier Communications Corporation (“Frontier”) is a publicly traded holding company  
serving 2.2 million lines, primarily in suburban and rural areas, in 24 states through its local  
exchange operating subsidiaries.<sup>3</sup>

5 On May 13, 2009, Frontier and Verizon entered into an Agreement and Plan of Merger  
(the “Merger Agreement”) under which Frontier, through the acquisition of stock, will acquire  
approximately 4.8 million access lines and related assets currently owned by subsidiaries of  
Verizon in Arizona, Idaho, Illinois, Indiana, Michigan, Nevada, North Carolina, Ohio, Oregon,

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<sup>1</sup> Joint Application at 5.

<sup>2</sup> *Id.* at 4.

<sup>3</sup> *Id.*

South Carolina, Washington, Wisconsin and West Virginia as well as a small number of access lines in California bordering Arizona, Nevada and Oregon.<sup>4</sup> The business that Frontier will be acquiring comprises the legacy incumbent local exchange carrier (ILEC) operations of Verizon in Washington and the other states, as well as related lines of business including toll, DSL, and Verizon's fiber-to-the-home (FiOS) operations in those states, but excluding the wireless, enterprise-oriented (i.e., service to very large business and government customers), and international business operations of Verizon.<sup>5</sup>

6           The Merger Agreement and Distribution Agreement are designed to: (a) establish a separate entity (variously referred to in the company testimony as "Spinco," "North Central Region" or "VSTO" for Verizon Separate Telephone Operations) as the holding company for Verizon's local exchange, long distance and related business activities in the acquired Territory; (b) spin-off the stock of that new entity to Verizon shareholders; and then (c) immediately merge the new entity into Frontier.<sup>6</sup>

7           At the completion of the transaction, Verizon Northwest will be a wholly-owned, indirect subsidiary of Frontier (albeit with a different name, Frontier Northwest) and will continue to provide local exchange service in the territory it serves today. Frontier also will own and control NewLD, which will provide long distance services in Washington.<sup>7</sup>

8           Upon closing, Frontier will change the name of Verizon Northwest; and it indicates that it will make all necessary filings to accomplish the name changes. Similarly, it states that any subsequent service or price changes will be made in accordance with all applicable laws, rules and Commission orders.<sup>8</sup>

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<sup>4</sup> *Id.* at 5, 6.

<sup>5</sup> Roycroft, TRR-1HCT at 7, 8.

<sup>6</sup> Joint Application at 6.

<sup>7</sup> *Id.* at 7.

<sup>8</sup> *Id.* at 8.

9           At the completion of the transaction, Frontier will own and control (and its board of directors will manage) both the Verizon assets being transferred to it through the Transaction at issue here, as well as its current properties. Specifically, in Washington, Frontier will own and control Verizon Northwest and two long distance companies: Frontier Communications of America, Inc. and NewLD.<sup>9</sup>

10           In their Joint Application, filed May 29, 2009, Verizon and Frontier sought Commission approval of the proposed transaction under the “Transfer of Property” statute and rules set forth in Chapter 80.12 RCW, Chapter 480-143 WAC.

11           Verizon and Frontier have entered into settlement agreements that resolve all issues among the various competitive local exchange carrier (CLEC) interveners, the Department of Defense and all other federal executive agencies (DoD/FEA) in their consumer capacity, and the Commission Staff. Public Counsel and interveners Broadband Communications Association of Washington (BCAW) and the International Brotherhood of Electrical Workers (IBEW) did not join in the settlements. Only Public Counsel actively opposes approval of the transaction under the terms set forth in the various settlement agreements. The settlements, if adopted by the Commission, would require Frontier (and to some extent Verizon) to adhere to certain commitments as conditions of approval of the proposed transaction.

### III. PERTINENT STANDARDS

#### A. The “No Net Harm” Standard

12           The standard set in the Commission’s rule is a “public interest” standard.<sup>10</sup> In the *Scottish Power* proceeding, the Commission held that this standard requires a showing of “no harm”:

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<sup>9</sup> *Id.* at 7.

<sup>10</sup> WAC 480-143-170 reads as follows: “If, upon the examination of any application and accompanying exhibits [under chapter 80.12 RCW], or upon a hearing concerning the same, the commission finds the proposed transaction is not consistent with the public interest, it shall deny the application.”

[T]he standard in our rule does not require the Petitioners to show that customers, or the public generally, will be made better off if the transaction is approved and goes forward. In our view, appellant's initial burden is satisfied if they at least demonstrate no harm to the public interest.<sup>11</sup>

In the *US West/Qwest* Merger Order,<sup>12</sup> the Commission stated:

There is no bright line against which to measure whether a particular transaction meets the public interest standard. As we observed in another recent merger case, 'the approach for determining what is in the public interest varies with the form of the transaction and the attending circumstances.'

13 Both the *US WEST/Qwest* order<sup>13</sup> and the *Verizon/MCI* order<sup>14</sup> identified the following factors for review in a merger proceeding:

- The impact on competition at the wholesale and retail level, including whether the transaction might distort or impair the development of competition;
- Whether the surviving corporation has the technical, managerial and financial capability to operate the operating subsidiary;
- The potential impact on service quality, including the impact on investment in Washington and neglect and abandonment of facilities;
- How any benefits or synergies would be shared between customers and shareholders;
- The financial impacts of the proposed merger on cost of capital, capital structure, and access to financial markets;
- The impact of the merger on rates, terms, and conditions of service.

14 Although telecommunications company applicants need not show a net benefit to consumers from a proposed transaction,<sup>15</sup> the Commission may consider positive benefits in one area as a means of offsetting costs in another. In other words, the Commission has been willing

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<sup>11</sup> *In the Matter of the Application of Pacific Corp. and Scottish Power, PLC*, Docket No. UE-981627, (3<sup>rd</sup> Supplemental Order on Prehearing Conference, April 1999); see also *In Re Application of US WEST Inc. and Qwest Communications International, Inc.*, Docket No. UT-991358 (9<sup>th</sup> Supplemental Order, June 19, 2000).

<sup>12</sup> *In Re Application of US WEST Inc. and Qwest Communications International, Inc.*, Docket No. UT-991358 (9<sup>th</sup> Supplemental Order, June 19, 2000) at pages 8-9.

<sup>13</sup> *Id.*, pp. 4-5.

<sup>14</sup> *In the Matter of the Joint Application of Verizon Communications, Inc. and MCI, Inc.*, Docket No. 050814 (Order No. 7, Dec. 23, 2005) at page 26.

<sup>15</sup> "The legislature finds and declares that the Washington utilities and transportation commission should require that a net benefit to customers be shown in order to approve the acquisition of the franchises, properties, or facilities owned by a gas or electrical company in the state and which are necessary or useful in the performance of the duties of a gas or electrical company, and that its decision to approve or deny such an acquisition should be made within a prescribed period of time." [Emphasis added.] Laws of 2009, c 24 § 1.



to balance “the costs and the benefits for the public and for affected customers.”<sup>16</sup> The existence of costs does not, in itself, require rejection. However, “[i]f the costs outweigh the benefits, the result is harm and the Commission should deny or condition the approval so no net harm results.”<sup>17</sup> Staff agrees with Frontier that the “no harm” standard should not be equated to a “no risks” standard as all merger and acquisition transactions, not to mention the ordinary operation of a business, involve some level of risk. A risk should be considered a cost or harm only when there is evidence of a substantial probability of occurrence.

## **B. Settlement Rules**

15           The standard by which the Commission evaluates a proposed settlement is set out in WAC 480-07-740: “The commission must determine whether a proposed settlement meets all pertinent legal and policy standards.” This involves the consideration of a record, the weighing of evidence often including oral testimony, and an evaluation of whether the proposal is consistent with the public interest.

16           In this matter, some of the parties reached settlement, while others did not. This is called a “multiparty settlement.”<sup>18</sup> Multiparty settlements must be reviewed through a process that allows proponents to support the proposal and non-settling parties to oppose it. Opponents must have the opportunity, among other rights, to see and cross-examine the evidence in support of the proposed settlement, and to present evidence or an offer of proof opposed to the settlement.<sup>19</sup>

## **IV. COSTS AND BENEFITS OF THE TRANSACTION**

### **A. Public Interest Rationale for the Transaction**

17           For the last few years, wireline telephone companies like Verizon and Frontier have been losing voice service customers and associated revenues in significant numbers. These “line

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<sup>16</sup> *Verizon Communications, Inc.*, Docket No. 050814 (Order No. 7, Dec. 23, 2005) at page 26.

<sup>17</sup> *Id.*

<sup>18</sup> WAC 480-07-730(3).

<sup>19</sup> WAC 480-07-740(2)(c).

losses” are attributable to consumers switching to the cable companies’ “triple play” (internet, video, and voice) offerings or choosing to “cut the cord” and rely solely on wireless service.<sup>20</sup> In recent years Frontier has experienced average (though declining<sup>21</sup>) switched line loss of about 7 percent per year, while Verizon line counts in the VSTO service area have declined by 10 percent per year.<sup>22</sup> This case is largely about which parent company—Verizon or Frontier—will be better for the Washington local exchange business in this period of change. Put another way: Which of these companies is more likely to preserve the revenue generating capacity of Verizon Northwest’s wireline network in Washington and that operating company’s ability to fulfill its carrier of last resort obligations as the owner of the ubiquitous fiber optic and copper loop network?

18           There is no dispute that Verizon is much larger and more diversified than Frontier, with a large and very lucrative wireless business. On a total company basis, Verizon has a higher credit rating than Frontier, suggesting that it is able to obtain both debt and equity financing at lower cost than Frontier. As such, it might appear that transferring control of Verizon Northwest to a smaller and less diversified parent is contrary to the public interest because it will necessarily translate to higher debt and equity costs and perhaps an inability to raise necessary capital. In Staff’s view, this is not the correct conclusion.

19           Frontier makes a compelling case that Verizon’s diverse lines of business—and competing investment objectives—are a curse rather than a blessing for Verizon’s Washington wireline customers. Frontier asserts that because the wireline business in less dense service territories has the lowest potential return among all of Verizon’s lines of business, Verizon has not invested as much as it should in increasing the wireline network’s ability to deliver

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<sup>20</sup> See Roycroft, TRR-1HCT at 20, 21; Liu, JL-1HCT at 5.

<sup>21</sup> McCarthy, DM-8HCT at 24, 25.

<sup>22</sup> McCarthy, DM-1T at 11.

broadband internet access services in addition to narrowband voice services, and Verizon is unlikely to invest as much in the future as Frontier would. Verizon admittedly wants out of its rural local exchange properties because it would rather focus on growth opportunities in wireless and enterprise services, and fiber-to-the-home (video, internet and voice) service where population is more dense.

20           Frontier witness (and Treasurer) David Whitehouse makes the point that “just because a business—such as the VSTO business—is part of a broader set of operations under a single corporate umbrella does not mean that it will have equal access to the resources of the consolidated entity.” Similarly, Frontier witness (and Chief Operating Officer) Daniel McCarthy states that “the Commission should understand that diversified carriers, such as Verizon, have made strategic business decisions to direct their capital resources toward growth objectives like wireless. As a result, other Verizon operations such as the lower-density local exchange operations of VSTO must compete for capital. Frontier’s strategic commitment to its markets is clear and without strategic conflicts, and the proposed transaction will produce demonstrable public benefits for Washington customers....”<sup>23</sup> Specifically, Frontier indicates that it intends to commit relatively more capital and more management attention to serving the ILEC businesses that it is acquiring.<sup>24</sup>

21           Public Counsel witness Trevor Roycroft, states that companies like Frontier, “which do not have wireless affiliates, and provide video primarily through a partnership with a satellite television company, face strong pressures to cut costs, and increase revenues from remaining landline customers.”<sup>25</sup> Frontier believes there are economic opportunities for it in the less dense local exchange properties Verizon is willing to sell. Frontier states that its strategy is based on

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<sup>23</sup> McCarthy, DM-8HCT at 10.

<sup>24</sup> DW-1T at 49, 50.

<sup>25</sup> Roycroft, TRR-1HCT at 21, 22.

committing to an upgraded network that is capable of providing high-quality innovative broadband and communications services to its customer base, complemented by high-quality customer service.<sup>26</sup> Frontier points out that its locally-focused operations organization has been successful in the past at stemming line loss and achieving higher per line revenues and it believes it can repeat those successes in the properties it seeks to acquire from Verizon. Frontier expects to slow down Verizon's rate of access line loss by increasing the number of high-speed internet customers through infrastructure investment. It also expects to increase the revenue realized per line by offering certain unregulated add-on services that Verizon does not offer. With higher per customer revenues and lower operating costs, Frontier expects to be able to maintain a financially viable enterprise.

22 By tripling the size of the company from 2.2 million access lines to 6.7 million, Frontier expects that its economies of scale will be increased and that it will provide a leaner overhead structure than currently exists for the VSTO properties. Although Frontier will take on additional debt as a result of the transaction, the merged company will actually be much less leveraged than the current Frontier, will compare favorably in terms of credit rating and leverage ratio to other local exchange carriers including CenturyLink and Qwest, and has a positive outlook from some rating agencies to achieve an investment grade credit rating (which only CenturyLink, Verizon and AT&T presently enjoy in the telecommunications industry).<sup>27</sup>

23 Public Counsel's witnesses speculate that Frontier may have a difficult time delivering on its promises of decreased line loss, high retail service quality, and increased broadband availability (these assertions and the Joint Applicants' responses are discussed in detail in Section IV.B below). However, while Public Counsel is skeptical of Frontier's ability to deliver

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<sup>26</sup> McCarthy, DM-8HCT at 19.

<sup>27</sup> See Section IV.B.1, 2, below.

on its promises, Public Counsel also makes some implicit assumptions about Verizon's comparative ability or willingness to deliver benefits, if it were to retain ownership, that Staff believes to be unfounded. Chief among those is the assumption that Verizon's wireless subsidiary can be expected to subsidize ("offset losses") to its wireline operating companies, and that Verizon would make the investment necessary to replace the ubiquitous copper network with a new, and very costly, fiber-to-the-home ("FiOS") network in rural areas of Washington. Verizon's comparative dearth of investment in expanding digital subscriber line (DSL) service availability and its desire to exit its less densely populated service territories indicate otherwise. Verizon has no plans to extend its FiOS footprint beyond its current commitments in various franchise agreements,<sup>28</sup> and Verizon has indicated that it has no plans to materially extend broadband availability in its Washington service area beyond the reach of its current broadband-capable network.<sup>29</sup> While broadband Internet access can be provided over a number of technological platforms, including coaxial cable, fiber optic cable and various wireless access technologies, Frontier's future focus in Washington is mainly on expanding DSL capability over the existing copper loop telephone network.<sup>30</sup> This approach to network investment is prudent and will allow the transferred telephone plant to evolve toward constantly improving broadband speeds available to a very high percentage of customers.<sup>31</sup> In Staff's view, this approach is consistent with the vital public interest objective of preserving the revenue-generating capacity of the wireline network so that it will continue to be available for the provision of basic telecommunications service at affordable rates throughout the local exchange company's service

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<sup>28</sup>TM-11, which is a DR response says: "Verizon has not targeted investment in Washington for broadband deployment except where it has [an] existing, unfulfilled obligation to deploy FiOS." In Washington, FiOS passes █ percent of the homes in Verizon's service territory. McCarthy, DM-8HCT at 20, 21.

<sup>29</sup> McCarthy, DM-8HCT at 26.

<sup>30</sup> Liu, JL1-HCT at 4.

<sup>31</sup> McCarthy, DM-8HCT at 27.

territories. Expanding the availability of high speed internet access over the existing wireline network serves the universal service objectives of ubiquitous, high quality, and affordable basic voice service for a number of reasons.

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First, when rates are determined for tariffed local exchange service (or when a rate cap or similar mechanism is designed for an alternative form of regulation after a full earnings review), the cost of the local exchange company's loop plant is a significant rate base element. To the extent that the loop plant can be used to generate revenue from unregulated information services and interstate telecommunications services in addition to basic local exchange service, those revenues can be recognized as contributing to the recovery of loop costs.<sup>32</sup> While DSL service used to be considered an auxiliary service over the telephone network, data and voice services have switched roles in recent years as broadband Internet access has become more widely adopted. Broadband revenue has become an increasingly large portion of telephone companies' overall revenue and likely will continue. As such, Frontier will rely more and more on its revenue from broadband access services than on revenue from its traditional voice telephone services. As such, DSL deployment is a key factor that determines a local exchange company's financial health. As Mr. McCarthy stated in his direct testimony, the key growth market for a provider like Frontier is to reach a relatively higher penetration of broadband in less-dense regions.<sup>33</sup> From Frontier's perspective, the low broadband availability and subscriber rate in Verizon service territory in Washington presents opportunities for future growth that Verizon has not tapped into.<sup>34</sup>

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<sup>32</sup> *WUTC v. US WEST Communications, Inc.*, Docket No. UT-950200 (15<sup>th</sup> Supplemental Order at pages 83-84). The Commission expressly rejected the approach of assigning shared loop costs to services on a percentage basis. The Commission set rates for regulated services so that the company's overall revenues (from regulated and unregulated services) were sufficient to cover its costs.

<sup>33</sup> DM-1T at 13.

<sup>34</sup> Liu, JL1-HCT at 6.

25           Second, Staff agrees with Frontier that broadband capacity is important to retain customers on the company’s network in response to competition from cable and wireless providers. Mr. McCarthy discusses in his direct testimony that the combination of various strategies, including aggressive marketing of DSL services, innovative promotion with a free personal computer for the “Free Ride” bundle, localized management, dedicated customer support, and computer backup and restoration services, have worked well in customer retention in Frontier’s current service territories. As a result, Frontier appears to have a slower annual loss of its access lines – 7 percent for its national operation, as compared to 10 percent for Verizon in the service areas Frontier is proposing to acquire.<sup>35</sup>

26           Third, making subscriber line DSL-capable can involve a number of network improvements, including investment in DSL Access Modules (DSLAMs), fiber optic cable in the loop, digital loop carrier remote terminals, power plant and advanced digital data transmission technologies. These upgrades are critical for a carrier to provide voice, data and video services over the same network. The increased deployment of fiber optic cable within the network (albeit not all the way to the customer’s home), as well as increased switching capacity, will make the overall network more efficient. More managerial attention and technical support will also be given to common facilities that support both voice and data services. Without investment in broadband technologies, the network will soon become antiquated.<sup>36</sup>

**B. Frontier’s Financial Fitness and Ability to Provide Promised Benefits**

27           As noted above, Public Counsel witnesses Stephen Hill and Trevor Roycroft oppose the transaction based on the argument that Frontier may be unable to deliver on its promise of increased investment in the wireline network in Washington and to assure no net harm to Washington ratepayers. The following Section IV.B addresses concerns raised by Public

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<sup>35</sup> Liu, JL1-HCT at 5, referring to DM-1T at 11.

<sup>36</sup> JL1-HCT at 6, 7.

Counsel and Staff, and the Applicants’ analysis and rebuttal in response to those concerns. Staff believes that, with the addition of the protective measures in the various settlement agreements, the Applicants have met their burden of demonstrating *at least* an absence of net harm and arguably a net benefit, and the transaction should be approved. The terms of the settlement, together with Staff’s response to Public Counsel’s criticisms of the settlement terms, are set forth in Section IV.C, below.

**1. Frontier’s Relative Financial Strength**

28 **Significance of the Companies’ Relative Credit Rating--** Both Staff and Public Counsel raised concerns in their pre-filed testimony about Frontier’s below “investment grade” BB credit rating (BB is the highest rating below investment grade) as compared with Verizon’s company-wide A rating (investment grade). Staff’s concern was that by becoming part of a business organization with a lower credit rating than Verizon, the local operating company would eventually have to recover higher debt and equity costs from Washington ratepayers.

29 In rebuttal testimony, Frontier responded as follows:

30 First, Frontier witnesses presented financial analysis and data to show that the combined company will “have credit metrics superior to those of the other major non-RBOC<sup>37</sup> incumbent local exchange carriers (“ILECs”) except CenturyLink (the combined CenturyTel Inc. (“CenturyTel”) and Embarq Corporation (“Embarq”)). Qwest, an RBOC and the carrier serving the majority of Washington customers, has exactly the same ratings as Frontier.”<sup>38</sup> [T]he post-transaction financial profile of Frontier will be virtually the same as that of CenturyLink, which has the best credit profile of all the major independent telecommunications carriers.<sup>39</sup> Verizon is

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<sup>37</sup> Regional Bell Operating Company. Due to mergers, the only remaining RBOCs are Verizon, AT&T and Qwest.

<sup>38</sup> McCarthy, DM-8HCT at 12.

<sup>39</sup> *Id.*



only slightly less leveraged than the combined company will be.<sup>40</sup> The Commission recently approved the CenturyTel-Embarq merger which is very similar to the combination of Frontier with the VSTO operations—in terms of size, leverage, financial profile, and systems integration.<sup>41</sup>

31           Second, Frontier presented the findings of independent third parties, which recognize the benefits of the transaction for Frontier and in some cases project an investment grade rating.<sup>42</sup> According to Frontier’s Treasurer, David Whitehouse, Frontier has “committed to a leverage target of less than 2 ½ times net debt to earnings before taxes and depreciation and amortization. That is a very common benchmark metric [for] where you need to be to petition for an investment grade rating.”<sup>43</sup>

32           Third, the company stated that for purposes of future rate proceedings, the Commission would have the opportunity to address the appropriate debt and equity costs and potentially place a limitation on debt and equity costs to ensure that consumers experience no harm as a result of the transaction. The company pointed to Staff witness William Weinman’s proposed condition to mitigate this risk by providing that the cost of capital for purposes of an Alternative Form of Regulation (AFOR) “should be based upon ‘investment grade’ debt and equity because Verizon NW currently has an investment grade rating” and “Washington customer should not be required to bear higher capital costs due to Frontier’s lower rating.”<sup>44</sup>

33           Finally, Frontier argued that Verizon’s better overall credit metrics must be taken in context of Frontier’s stronger strategic commitment to invest in the wireline business. The focus on the comparative credit rating “overlooks substantial net benefits in terms of the major

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<sup>40</sup> *Id.*

<sup>41</sup> *Id.*

<sup>42</sup> DW-1T at 31.

<sup>43</sup> TR. 493.

<sup>44</sup> McCarthy, DM-8HCT at 15, 16, citing Weinman, WHW-1T at 25.

commitments Frontier has detailed regarding enhanced capital investment and improved strategic focus on Washington customers.”<sup>45</sup> The relative credit ratings mean little for the public interest if the companies in question are not dedicated to devoting capital to serving the relevant customer base.<sup>46</sup>

34 Staff agrees the Commission should not adopt “investment grade” as a test for fitness. There is only one major independent ILEC in the industry with an investment grade rating—CenturyLink.<sup>47</sup> Every carrier, other than AT&T has a leverage ratio that is inferior to Verizon’s.<sup>48</sup> As such, a rejection of the transaction solely on the basis of Frontier’s lesser credit rating would mean that Verizon would have extremely limited options for finding an owner for properties it acquired from GTE ten years ago,<sup>49</sup> and which it no longer finds to be a core part of its business.

35 **Dividend Policy and Book Equity Balance--** Both Staff and Public Counsel raised concerns in pre-filed testimony about the Frontier parent company’s policy over the last five years (2004-2009) of paying dividends in excess of “net earnings” (or as a high percentage of free cash flows) with the apparent result of a high ratio of debt to common equity.<sup>50</sup>

36 On rebuttal, Frontier responded as follows:

37 First, Frontier questioned the premise that dividends should be measured solely, or even primarily, against net income or earnings per share.

The appropriate financial analysis, and the analysis required by the financial markets, evaluates dividend payments in relation to free cash flow. Book net income is an accounting calculation that contains numerous non-cash entries, like depreciation, amortization, pension expense and income taxes (which can be positive or negative in any given period). In addition, book net income excludes capital expenditures, a major

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<sup>45</sup> McCarthy, DM-8HCT at 12.

<sup>46</sup> DW-1T at 23, 23.

<sup>47</sup> DW-1T at 25.

<sup>48</sup> DW-1T at 21.

<sup>49</sup> Docket No. UT-981367.

<sup>50</sup> Hill, SGH-1HCT at 20. Roycroft TRR-1HCT at 55-57; Weinman, WHW-1T at 9.

utilization of cash in the ILEC business. Free cash flow, which is calculated after all cash outflows including capital expenditures, better defines a company's ability to pay appropriate returns to its shareholders while maintaining a sustainable business.<sup>51</sup>

Mr. Whitehouse also questioned the premise that "a company will not be financially sound if its book equity balance varies over time." As evidence, he noted that Qwest has a negative book equity account of more than \$1 billion and that Embarq, the former parent company of United Telephone Company of the Northwest, "had a negative equity balance for most of its corporate life after the operations were spun-off from Sprint Corporation with the approval of this Commission, but it had a substantial market capitalization as the financial community valued operations, not on book equity, but on projected cash flows."<sup>52</sup> He also noted that Comcast, one of the chief cable company competitors against the ILECs in the market for voice and high speed internet, "had a book value of \$40.450 billion but goodwill of \$14.928 billion and intangible assets of \$63.743 billion, so that net tangible book value was a negative \$37.253 billion" at the end of the second quarter of 2009. "However, the financial markets perceive value above that negative balance and evaluate Comcast on its cash flow generation. The public market value for Comcast's equity, as of Tuesday, November 3, 2009, was \$41.64 billion."<sup>53</sup>

38           Second, Frontier emphasized that the transaction will have the effect of substantially "deleveraging" the company's balance sheet. The company has also announced its intention to reduce its dividend by 25 cents from its historical level of one dollar and has a goal of achieving and maintaining an investment grade rating.<sup>54</sup> Although there is new debt associated with the transaction, cash flows (based on year end 2008 data for Frontier and VSTO) rise to proportionally greater degree than does debt,<sup>55</sup> resulting in a combined company leverage ratio

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<sup>51</sup> Whitehouse, DW-1T at 38.

<sup>52</sup> Whitehouse, DW-1T at 43.

<sup>53</sup> Whitehouse, DW-1T at 64.

<sup>54</sup> Whitehouse, TR. 493, 557.

<sup>55</sup> Whitehouse, DW-1T at 16.

(net debt divided by Earnings before Interest Expense, Taxes, Depreciation, and Amortization – EBITDA) that is significantly lower than Frontier’s current leverage ratio of 3.8 times (based on 2008 financial data). Because of the very low 1.7 times leverage ratio of the VSTO properties that Frontier is acquiring, the combined company will enjoy an overall leverage ratio of 2.6 times using 2008 financial data, before considering the benefit of expected cost savings. With synergies, the ratio would improve to 2.2 times.<sup>56</sup> By comparison, CenturyLink was expected to have a 2.3 times leverage ratio before synergies and 2.1 after synergies.<sup>57</sup> CenturyLink maintained an investment grade rating.<sup>58</sup>

39           Third, Frontier pointed out that during the 2005 to 2008 period (when Staff and Public Counsel suggested dividends were excessive), “Frontier generated free cash flows that ranged from approximately \$493 million to \$562 million annually. Notably, Frontier achieved these levels of free cash flow while simultaneously investing over \$1.1 billion cumulatively over the four-year period in its operations and network, including broadband plant.”<sup>59</sup> Mr. McCarthy asserted that “Frontier *has* built additional broadband infrastructure”—92 percent average availability rate across its service territories as compared with Verizon’s 60 percent in the VSTO territories—“and invested in an [operations support] system that handles our 2.2 million customers today, with a dividend payout level that is higher than projected on a pro forma basis post close.”<sup>60</sup> The proposed transaction is expected to *increase* Frontier’s annual free cash flow, based on pro forma 2008 results, to over \$1.4 billion, without synergies, and over \$1.7 billion after estimated synergies are included.<sup>61</sup>

40           Fourth, Frontier challenged the assertion, implicit in Staff and Public Counsel’s concerns

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<sup>56</sup> Whitehouse, DW-1T at 15.

<sup>57</sup> Whitehouse, DW-1T at 17.

<sup>58</sup> *Id.*

<sup>59</sup> Whitehouse, DW-1T at 39.

<sup>60</sup> McCarthy, DM-8HCT at 19.

<sup>61</sup> DW-1T at 39.

regarding dividends, that there is any incentive to pursue a dividend policy that is in conflict with the underlying business. Mr. McCarthy stated:

Equity capital sources, like other sources of capital such as debt or operating cash flows, are necessary to pay for operations and investment. All of those sources have market-based costs, and the cost for equity in the ILEC business is captured primarily in dividends. The intervenors suggestion that payment of dividends somehow conflicts with the business interests of ILECs does not reflect that business management, equity-holders, and debt-holders are all working in concert to provide a long-term, viable business. Frontier must properly address all of these capital sources to succeed in the competitive marketplace.<sup>62</sup>

Staff believes that Frontier has demonstrated that the transaction will allow it to obtain more competitively-priced funding by reducing the pro forma company's leverage ratio, gaining liquidity by increasing the number of shares outstanding, and providing the opportunity to realize efficiencies. As Mr. Whitehouse states, these factors reduce the dividend per share, as investors will focus on the potential for cash flow growth, which combines with the dividend to create appropriate returns.<sup>63</sup>

## **2. Frontier's Savvy and Diligence as a Purchaser**

41 **Valuation of the VSTO Properties**—In pre-filed testimony, Public Counsel witness Stephen Hill speculated that the valuation of the carved-out VSTO properties that Frontier is acquiring from Verizon is likely too high. The only basis for Mr. Hill's assertion is that Verizon determined the allocation of shared costs for the VSTO properties and, according to Mr. Hill, had an incentive to overstate the value.<sup>64</sup>

42 Verizon Vice President for Business Development, Stephen Edward Smith, responded to Mr. Hill's assertions as follows:

Mr. Hill makes inflammatory inferences without any evidence, which should be given no weight. The testimony, which borders on accusing Verizon of improper behavior, is inappropriate. Verizon does not "shape" financial information, and

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<sup>62</sup> DW-1T at 31, 32; *see also Id.* at 41.

<sup>63</sup> DW-1T at 41.

<sup>64</sup> SGH-1HCT at 4; TR. 605:7 – 606:16.

Mr. Hill's premise is fundamentally flawed, as Verizon would not benefit from preparing misleading financial statements for Verizon's Separate Telephone Operations ("VSTO").<sup>65</sup>

Frontier's Treasurer, Mr. Whitehouse also called Mr. Hill's speculation "unfounded and troublesome."<sup>66</sup>

43           The Company witnesses point out that no special procedures were used to create the VSTO financials.<sup>67</sup> Verizon used the same accounting policies and practices it has historically used to prepare the consolidated financial statements of Verizon as well as its separate operating companies, including those comprising the VSTO. Verizon's internal controls are tested annually by its independent registered public accounting firm, Ernst & Young LLP ("E&Y"), in compliance with the provisions of the Sarbanes-Oxley Act of 2002.<sup>68</sup> The financial statements are audited by E&Y and used in registration statements filed with the Securities and Exchange Commission.<sup>69</sup>

44           As to the ability to "shape" the financials, both companies point out that "revenues are *not* allocated, but rather are reported based on state specific information and billing system data. Similarly, operating expenses are also reported based on state specific data wherever possible. Such expenses include salaries and wages and related expenses of employees located in VSTO states and depreciation expenses of fixed assets located in VSTO states."<sup>70</sup> "[T]he debt of VSTO is either existing debt issued by the operating companies to third parties, whose principal amount is clearly known and verifiable, intercompany indebtedness that will be *cancelled* prior to closing, or new debt that will be incurred prior to closing at the parent level."<sup>71</sup> "Verizon's VSTO operations have verifiable revenue streams, assets and personnel, which form a significant

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<sup>65</sup> Smith, SES-1T at 33.

<sup>66</sup> DW-1T at 49.

<sup>67</sup> Smith, SES-1T at 35.

<sup>68</sup> Smith, SES-1T at 33, 34.

<sup>69</sup> Smith, SES-1T at 34.

<sup>70</sup> Smith, SES-1T at 35.

<sup>71</sup> Smith, SES-1T at 36.

basis for understanding the historical financial performance and future prospects of the business.”<sup>72</sup> Mr. Smith points out that none of the sophisticated groups that have examined the VSTO financial statements – including Frontier’s management, Frontier’s shareholders (who will end up owning more than 65% of shares in the new Frontier), the financial analyst community, the banks that wrote Frontier’s fairness opinions, or the Securities and Exchange Commission – has joined Mr. Hill in his assessment.<sup>73</sup> Mr. Whitehouse, of Frontier, points out that “there is legal recourse available if there has been a material misrepresentation by Verizon regarding the financial performance of the VSTO operations, as Verizon will have to attest to the accuracy of its representations as part of the closing of the transaction (i.e., standard representations and warranties will be required of both Frontier and Verizon as part of closing).”<sup>74</sup>

45           Finally, Frontier’s Chief Operating Officer, Mr. McCarthy, notes with reference to Frontier’s experience acquiring telecommunications assets that:

Frontier is more experienced at acquiring and operating telecommunications assets than some intervenors are assuming and worked with experienced advisors in analyzing this transaction. The company understands the equipment, trends, valuations, and all the other issues associated with acquisitions, and acquiring telecommunications operations remains a core Frontier skill. . . . Frontier has engaged in a number of sizeable acquisitions of telecom operations over the last decade. Frontier and its management team have extensive “real world” transactional experience and expertise. The company’s projections of revenues and expenses related to the proposed transaction are grounded in that experience, and the company’s ability to value the resulting cash flows is sound.<sup>75</sup>

Staff is convinced that the purchase price for the VSTO properties was negotiated at arm’s length by a knowledgeable and experienced buyer based on accurate financial information. Mr. Hill’s speculation fails to rebut this evidence.

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<sup>72</sup> Whitehouse, DW-1T at 49.

<sup>73</sup> Smith, SES-1T at 36.

<sup>74</sup> DW-1T at 49, 50.

<sup>75</sup> McCarthy, DM-8HCT at 39, 40.

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**Frontier’s Diligence in Verifying the Condition of Outside Plant**—In pre-filed testimony, both Public Counsel and Staff questioned whether Frontier had done enough to verify the condition of physical plant assets being acquired, particularly outside plant. Public Counsel witness Trevor Roycroft even went so far as to state that Frontier had not “assessed either the condition of Verizon’s outside plant or the maintenance of that outside plant.”<sup>76</sup>

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In Staff’s view, Frontier’s early data request responses on this subject, prior to the company’s rebuttal testimony, were not as illuminating as they should have been, stating simply that no physical site visits had been performed and that no written reports or analyses existed. However, in its rebuttal testimony, Frontier finally presented a fuller explanation of its process for investigating the condition of the VSTO outside plant. “During the due diligence period . . . Frontier and Verizon engaged in numerous conference calls with subject matter experts who relied upon and further probed the data available electronically.”<sup>77</sup> Through this process, Frontier “had access to significant and sufficient information from Verizon; arguably more information than the company had prior to its other successful acquisitions over the last ten years.” The company defended its approach of using Verizon’s computer files as being more meaningful and efficient than physical site visits, as well as being consistent with current industry practice. Mr. McCarthy stated that, “[k]ey analytical resources are available [in computer files] and can be reviewed efficiently by far more personnel than was possible even ten years ago. In Frontier’s experience, visits to physical sites and assessments of individual central offices are not necessary when engaging in acquisitions of this sort.”<sup>78</sup>

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Staff accepts Frontier’s assertions and has also reviewed other data to come to the conclusion that Frontier has appropriately analyzed the condition of the plant it is acquiring. For

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<sup>76</sup> Roycroft TRR-1HCT at 75.

<sup>77</sup> McCarthy, DM-8HCT at 30.

<sup>78</sup> McCarthy, DM-8HCT at 16, 29, 30.



example, in response to Staff data requests, the Joint Applicants indicated that all of Verizon's switches are utilizing the most current generic upgrades. Staff also reviewed Verizon's trouble index and found that the company is meeting Commission standards.<sup>79</sup> These are strong indicators that the plant is modern and well-maintained.<sup>80</sup>

49           **Terms of Financing for Cash Payment**—The terms of the transaction require Frontier to obtain financing for a \$3.3 billion cash payment to Verizon at the close of the transaction. If Frontier is unable to obtain financing at a rate below 9.5 percent, it has the ability to pull out of the transaction.<sup>81</sup> Both Staff and Public Counsel expressed concern in pre-filed testimony regarding the inability to know the terms of this financing until shortly prior to the close of the transaction.<sup>82</sup>

50           In response, Frontier explained why it believes it will be able to obtain financing on favorable terms and at a rate that is substantially better than 9.5 percent. “One indicator of the financial markets’ assessment of Frontier’s creditworthiness came on September 17, 2009, when Frontier was able to arrange new debt financing to raise net proceeds of \$577.6 million (gross proceeds of \$600 million), through 8.125% (8.375% yield to maturity) Senior Notes due in 2018.”<sup>83</sup>

51           Staff believes that Frontier’s recent ability to refinance a significant amount of its debt on favorable terms, together with its improved creditworthiness as a result of the transaction will likely enable it to obtain financing below 9.5 percent. However, as described in the discussion of the settlement provisions, below, Staff believes that the Company should be required to return to

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<sup>79</sup> Weinman, TR. 349:5-15.

<sup>80</sup> Weinman, TR. 275:23 – 276:5.

<sup>81</sup> *Agreement and Plan of the Merger* §7.18(e)(ii).

<sup>82</sup> Roycroft TRR-1HCT at 62.

<sup>83</sup> DW-1T at 44; *see also* McCarthy, TR. 380 (predicting 8 3/8 percent and relatively non-restrictive covenants).

the Commission for a reassessment of the transaction in the unlikely event that it cannot obtain financing for the cash portion of the merger compensation at 9.5 percent or lower.

52           **Frontier’s Financial Projections**--Public Counsel witness Stephen Hill argues that Frontier’s post-merger financial projections are overly optimistic and “do not take into account the potential for substantial downside events.”<sup>84</sup> Mr. Hill argues on this basis that the Commission should be concerned about Frontier’s financial health and its ability to deliver on its promise of increased investment in the telephone network.

53           In response, Frontier points out that the pro forma revenue and expense projections that Mr. Hill cites as evidence of excessive optimism are in fact miscalculations or misinterpretations of the company’s modeling, and that Frontier’s actual assumptions about the decline or growth of costs and expenses are more conservative and are in line with the company’s historical performance.<sup>85</sup> Mr. McCarthy points out various miscalculations in Mr. Hill’s testimony regarding “the absolute level of projected VSTO operating expenses, the levels and trends of projected VSTO cash operating expenses per line per year, and the level of VSTO’s projected annual EBITDA per access line” which all have the tendency to make revenue growth and growth/decline in expenses potentially appear to be overly optimistic.<sup>86</sup>

54           In his rebuttal testimony, Mr. McCarthy provides a lengthy explanation of how, within the financial model for the combined company’s projected performance through 2014, all \$500 million of synergies that the company expects to attain post-merger are “parked” in the VSTO subsidiary merely as a modeling convention, while in fact the company expects those savings to be realized company-wide. Thus, by focusing on the VSTO subsidiary rather than the consolidated operations, Mr. Hill reached the incorrect conclusion that operating expenses must

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<sup>84</sup> SGH-1HCT at 4.

<sup>85</sup> DM-8HCT at 34.

<sup>86</sup> DM-8HCT at 35, 36.

dramatically decline solely in the former VSTO operations, when in fact, the savings are expected to be spread, less dramatically, over the whole combined company.<sup>87</sup>

Frontier is not projecting a dramatic change in expenses to the VSTO operations compared with the company's legacy operations. If Mr. Hill had focused on the consolidated projections, it would have become apparent that the model is entirely reasonable. Illustrating this, in 2014 the combined company is expected to generate a 52% EBITDA margin, which is consistent with the 2010 estimated EBITDA margin of 52% for the legacy Frontier business and is below Frontier's reported margin of 53.2% (excluding one-time early retirement costs and non-cash pension expenses, but including acquisition and integration costs) for the nine months ended September 30, 2009. So, Frontier's projections for operating cash flows are entirely realistic on a consolidated basis, which is the analysis for which the model was designed. The model assumes that the combined company will achieve the expected synergies and will have EBITDA margins that are slightly lower than those Frontier reports today. Frontier believes that such an assumption is entirely reasonable, and not "dramatic," as Mr. Hill has concluded.<sup>88</sup>

55            Frontier projects that it will achieve a total of \$500 million in synergy savings nationwide (representing 21% of total VSTO cash operating expenses) by 2013,<sup>89</sup> and Mr. McCarthy presents various statistics to show how this level of savings is consistent with other transactions in the industry and with Frontier's past acquisition integration experience.<sup>90</sup> However, the company emphasizes that the synergies are not necessary for the transaction to be successful or for the combined company to make necessary investments and remain financially fit.<sup>91</sup>

56            One concern raised by Staff was that the combined company might be constrained from raising equity financing in the two years following the transaction. In response, Mr. Whitehouse explained that, to the extent necessary, Frontier could always issue bonds or other debt

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<sup>87</sup> McCarthy, DM-8HCT at 37, 38.

<sup>88</sup> McCarthy, DM-8HCT at 38.

<sup>89</sup> McCarthy, DM-8HCT at 66.

<sup>90</sup> *Id.* at 66-68.

<sup>91</sup> Whitehouse, DW-1T and 55.

instruments and will in fact have substantial flexibility to issue up to 274 million new shares during the period, which might mean \$2.1 billion in new equity if the stock price were \$7.75.<sup>92</sup>

57           At hearing, Public Counsel placed a great deal of emphasis on the fact that the financial model employed by Frontier is not designed in such a way that a non-expert user (such as Public Counsel’s witnesses) could alter the assumptions with regard to factors such as line loss or lending rates in order to determine the impact on other financial measures. Given that Public Counsel has not put forward any evidence as to what a reasonable set of assumptions would be, however, it is hard to understand what point would be served by plugging in purely speculative assumptions to see what would result.<sup>93</sup>

58           Staff is convinced that Frontier has substantial expertise in issues associated with declining access lines, economic uncertainty, and the amount of financial information available with respect to the underlying revenues and costs. The company has successfully acquired and integrated properties over the last two decades and has apparently generated realistic projection models in those instances.<sup>94</sup> Staff also believes that the uncertain future affects all local telecommunications carriers, including Verizon, AT&T, Qwest, CenturyLink, Windstream and other ILECs. Staff therefore agrees with Mr. Whitehouse’s statement that: “If the industry forces were to be more negative than anticipated, they will be negative for all major Washington telecom companies—Frontier, Qwest, CenturyLink and others. I assert that it is better to have a dedicated operator that includes lower-density markets in its focus if new opportunities or challenges evolve.”<sup>95</sup>

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<sup>92</sup> DW-1T at 32, 33.

<sup>93</sup> This seems to be the intention of Public Counsel’s reference to an Oregon Commission bench request. *See* WHW-35.

<sup>94</sup> *See* McCarthy, DM-8HCT at 33.

<sup>95</sup> DW-1T at 54.

### 3. Frontier's Ability to Increase Broadband Deployment and Stem Line Loss

59 Much of Public Counsel and Staff's prefiled testimony raised questions as to Frontier's ability to deliver on its promise to increase broadband deployment and to achieve better results than Verizon has been able to achieve in holding market share against cable and wireless providers. Mr. Hill presented testimony purporting to show that Verizon has historically invested more than Frontier on a per line basis,<sup>96</sup> while Dr. Roycroft criticized Frontier for not offering specific commitments or details regarding plans for broadband deployment in Washington.<sup>97</sup>

60 In rebuttal testimony, Frontier presented evidence to show that Mr. Hill's statistics purportedly showing greater per line investment by Verizon are due to Verizon's investment in its combined fiber optic television, broadband and voice offering, called FiOS, which has benefited a very small percentage of voice customers at high cost. Across the VSTO service region, the percentage of FiOS data subscribers to total access lines was only 3% at the end of the second quarter of 2009. Thus, Verizon's aggregate capital expenditures in the VSTO service areas overlook the fact that a high percentage of those capital expenditures were directed toward serving a very small number of customers, while capital expenditures spent on the remaining customers were considerably lower than Frontier's historical investment levels.<sup>98</sup> In Washington, Verizon had deployed FiOS [REDACTED] [REDACTED] based on access lines in service at the end of 2008. Verizon has indicated that it has no plans to expand FiOS availability beyond build-out commitments it has made regarding video franchises in Washington.<sup>99</sup> FiOS

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<sup>96</sup> Hill, SGH-1HCT at 24.

<sup>97</sup> Roycroft TRR-1HCT at 74.

<sup>98</sup> McCarthy, DM-8HCT at 22, 23.

<sup>99</sup> TM-11, which is a DR response says: "Verizon has not targeted investment in Washington for broadband deployment except where it has [an] existing, unfulfilled obligation to deploy FiOS."

investment skews the total figures over recent years, providing a less than clear picture of the lower levels of investment in the vast majority of the non-FiOS network in the state.<sup>100</sup>

61 Mr. McCarthy presents extensive analysis of confidential information showing that, after removing FiOS plant expenditures, Frontier has historically invested more per dollar of revenue and per line than Verizon has in its VSTO territories. Citing public information, Mr. McCarthy compares Verizon’s average non-FiOS capital expenditures per line over the past two years of \$85 with Frontier’s average per line of \$126 and \$123 over the same two years (respectively).<sup>101</sup>

62 Mr. McCarthy also states that Frontier intends to make a total capital investment over four years in the VSTO areas of “[REDACTED]”  
[REDACTED]  
[REDACTED]”<sup>102</sup>

63 Frontier also presented evidence on rebuttal to show that it has historically been able to achieve higher broadband penetration than Verizon, higher overall per line investment (excluding FiOS), and lower line loss. “As of December 31, 2008, Verizon offered broadband service to approximately 60% of the customers in the combined VSTO service areas and to approximately [REDACTED] of households in its Washington service area. By contrast, as of that time, Frontier made broadband available to about 92% of its customer base, which is more impressive as those areas are on average more rural than the VSTO areas.”<sup>103</sup> Mr. McCarthy also notes that the Independent Telephone & Telecommunications Alliance (ITTA) performed a survey and commented before the FCC that the average broadband availability across the surveyed ITTA companies was 85%. Thus, “[u]p to this time, Frontier’s 92% broadband availability level is

<sup>100</sup> McCarthy, DM-8HCT at 20, 21.

<sup>101</sup> McCarthy, DM-8HCT at 22, 23.

<sup>102</sup> McCarthy, DM-8HCT at 26.

<sup>103</sup> McCarthy, DM-8HCT at 5.

well above the average of the surveyed mid-size carriers that also serve predominantly suburban and rural areas.”<sup>104</sup>

64 As evidence of the success of the strategy of pushing greater broadband availability as a means of stemming line loss, Frontier states that as its base of broadband subscribers has grown, “its access line loss rate, which was a comparatively low 7.2% in 2008, has slowed even more to approximately 6.5% for the twelve months ending June 30, 2009.”<sup>105</sup> By comparison, Verizon’s line loss has been at 10 percent.<sup>106</sup> Dr. Roycroft acknowledges that Frontier [REDACTED]  
[REDACTED]  
[REDACTED] (though he does dispute that it is due to Frontier’s particular offerings).<sup>107</sup>

65 In pre-filed testimony, Staff expressed concern that Verizon’s franchise commitments for FiOS build-out, which Frontier will take on in the merger, might deplete capital that would otherwise be used for Frontier’s plans to build out DSL to a greater percentage of customers. In response, Verizon witness Timothy McCallion indicates that the FiOS fiber system is substantially complete in Washington. As of the end of June 30, 2009 the system is [REDACTED] complete.<sup>108</sup>

66 Staff is convinced that Frontier will be able to deliver on its promise of investing more in the ILEC telephone plant in Washington than Verizon has demonstrated a strategic will to do. Moreover, Staff is convinced that Frontier’s plan to expand high speed internet availability and packages of services to compete against cable offerings is the key to stemming line loss and, ultimately, to retaining the revenue producing capacity of local exchange network.

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<sup>104</sup> McCarthy, DM-8HCT at 23.

<sup>105</sup> McCarthy, DM-8HCT at 24, 25.

<sup>106</sup> McCarthy, DM-1T at 11.

<sup>107</sup> Roycroft TRR-1HCT at 71 HC.

<sup>108</sup> TM-2HCT at 34.

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Public Counsel faults Frontier for not yet having developed a capital budget for Washington State. The company responds that an acquiring company typically does not develop state specific capital budgets before closing a merger, but points to its company-wide capital expenditure projections, referenced above.<sup>109</sup> Staff considered those projections in negotiating broadband buildout commitments from Frontier for the state of Washington, as discussed in detail below.

**C. Verizon and Frontier’s Ability to Provide Seamless Operational Support System Transition**

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Much of the initial concern about the proposed transaction on Staff and Public Counsel’s part arose from the history of Verizon’s sale of its Hawaiian Tel properties to the Carlyle Group, and from Verizon’s sale of its properties in Maine, New Hampshire, and Vermont to FairPoint Communications. In those transactions, Verizon sold ILEC properties to purchasers who proved unable to smoothly cut over from Verizon’s operations support systems (OSS) to the purchasing company’s newly developed OSS. The result was service quality problems that lead to competitive line loss and ultimately to the need for the acquiring carriers to seek Chapter 11 protection.<sup>110</sup> Operations support systems are the computer hardware and software that perform management, ordering, inventory, engineering, planning, repair, and billing functions for telecommunications service providers.<sup>111</sup>

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The Joint Applicants provide a three part response to concerns about OSS conversion and integration in their rebuttal testimony. First, they explain their understanding of the problems associated with Hawaiian Tel and FairPoint transactions (in particular, the acquiring companies’ “decision to create entirely new—and eventually ineffective—operational support systems and to

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<sup>109</sup> McCarthy, TR. 378, 79.

<sup>110</sup> Williamson, RTW-1HCT at 7-10; Roycroft, TRR-1HCT at 9-12.

<sup>111</sup> See Williamson, RTW-1HCT at 2-6.



cut over to those systems prematurely.”)<sup>112</sup> Second, they explain how the present transaction is structured to avoid those problems by having Verizon create a copy of its existing systems which Verizon will use for its own day-to-day operations for 60 days, and which it will turn over to Frontier at the close of the transaction along with the personnel who presently operate the systems. After close, Frontier may migrate the VSTO customers over to Frontier’s existing systems at an unhurried pace and at its own election. Third, Frontier presents evidence of its history of competently acquiring and converting OSS from other carriers, including former GTE systems like those used by Verizon Northwest and all of the other VSTO states except West Virginia.

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**Root Cause of the FairPoint and Hawaiian Tel OSS Problems**—Frontier presented the testimony of a consultant, Wayne Lafferty, who was previously retained by the Vermont Public Service Department to advise on the FairPoint transaction within that state. He testifies to the differences between the FairPoint transaction and the present transaction.<sup>113</sup> Mr. Lafferty explained that the service quality, operating and financial problems were the result of FairPoint’s decision to create entirely new and untested operational support systems in northern New England.<sup>114</sup> Verizon’s witness Stephen Smith, Vice President for Business Development, presents this same conclusion and provides additional explanation.<sup>115</sup> Mr. Smith also states that Verizon has undertaken over 50 access line transfers to small regional providers to mid-sized companies including CenturyTel, Windstream, and Frontier. “In all other cases, the systems transitions (including the data cutovers) went smoothly and the acquiring company was able to successfully operate the acquired assets using established, proven operating systems.”<sup>116</sup>

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<sup>112</sup> McCarthy, DM-8HCT at 17.

<sup>113</sup> Lafferty, FWL-8T at 3.

<sup>114</sup> Lafferty, FWL-8T at 18; McCarthy, DM-8HCT at 55.

<sup>115</sup> Smith, SES-1T at 5-7.

<sup>116</sup> *Id.* at 8, 9.

Frontier also presents various statistics to show that Frontier is substantially larger, considerably less leveraged, more conservative in its dividend policy, and more qualified from an existing systems perspective.<sup>117</sup>

71            Frontier also argues that the 2005 Hawaiian Tel divestiture to a private equity investor, The Carlyle Group, is different from the present transaction. Carlyle had limited or no experience in operating a local telephone company. According to Frontier, “[t]he root problems, therefore, arose because of the need to assemble an entirely new management team and the inability to install and operate an effective and entirely new back-office system.<sup>118</sup>

72            In short, the problems in those transactions were traceable to undeveloped OSS systems and inexperience on the part of the acquiring companies.<sup>119</sup> There is also some suggestion that the problems in the prior transactions had to do with the fact that the transactions involved the acquiring companies taking on substantial debt. Mr. Hill of Public Counsel acknowledges that this is not the case in the present transaction. Hill admits:

The proposed transaction between Verizon and Frontier is structured differently than Verizon’s divestiture of Hawaiian Telcom, Idearc (yellow page operations), and the spin-off of five million access lines in New England to FairPoint Communications. While the first two transactions were heavily leveraged (used mostly debt to finance the sale), this transaction is financed primarily through the issuance of a very large amount of shares of Frontier’s equity capital.<sup>120</sup>

73            **Verizon and Frontier Approach to Systems Conversion**—Frontier and Verizon assert that the present transaction is structured to avoid the problems of the Hawaiian Tel and Frontier transactions. Specifically, there will be no immediate change in the systems that are utilized to serve customers:

In situations where systems that have been used to support local exchange carrier operations remain exclusively with the seller, the buyer must develop new, or

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<sup>117</sup> McCarthy, DM-8HCT at 56.

<sup>118</sup> McCarthy, DM-8HCT at 62, 63.

<sup>119</sup> Id. at 18.

<sup>120</sup> SGH-1HCT at 17.

modify existing systems to provide service to the customers after the transaction is completed. Then the seller and the buyer must complete a cutover at a specific date/time, whereby the customer's data and service support functions are moved to the newly developed systems and the buyer assumes responsibilities for providing service on an ongoing basis using those systems. This scenario does not exist in Washington because Frontier will be using the *same systems* in place at Verizon prior to the transaction and will have the advantage of employees experienced with those systems that will continue with the business.<sup>121</sup>

Although the systems will be the same, it will be necessary for Verizon to copy or replicate those systems by loading software and data onto new hardware that will be transferred to Frontier at closing.<sup>122</sup> (Verizon Northwest has continued to use the centralized computer systems that Verizon obtained from GTE and has modified and improved them since closing that transaction in 2000. These systems are the basis of the Verizon OSS involved in this transaction, and are used to run essential aspects of the business, such as retail ordering and billing, CLEC ordering and billing, network monitoring and maintenance, and all customer support functions. Verizon chose to keep the GTE systems rather than merge them into the other non-GTE Verizon legacy OSS.<sup>123</sup>) The Agreement and Plan of Merger provides as follows:

Prior to March 31, 2010, Verizon shall create a separate instance in the Fort Wayne, Indiana data center (the "Fort Wayne Data Center") of Verizon proprietary software systems that will enable Spinco (and following the Merger, the Surviving Corporation) in all states in the Territory (other than West Virginia) to provide functionality substantially similar to, but no less favorable to the Spinco Business than, that which the Spinco Business received from Verizon and its Affiliates as of the date of this Agreement. As of the Closing Date, the Fort Wayne Data Center (i) shall be owned by the Surviving Corporation or an Affiliate thereof and (ii) shall have on site a majority of the hardware reasonably required to provide functionality to the Spinco Business in accordance with the foregoing (and the balance of such hardware, if not held at the Fort Wayne Data Center, shall be available on a firewall basis from Verizon or a Verizon Subsidiary for up to one year following the Closing to allow for Verizon to transfer such hardware to the Fort Wayne Data Center within one year following the Closing).<sup>124</sup>

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<sup>121</sup> Direct Testimony of Daniel McCarthy, p. 52, lines 9-18, emphasis added.

<sup>122</sup> Williamson, RTW-1HCT at 15.

<sup>123</sup> Williamson, RTW-1HCT at 14.

<sup>124</sup> *Agreement and Plan of the Merger* §7.24(c), p. 112.

Verizon will use the replicated systems in live production to serve retail customers, business customers, and wholesale customers for 60 days prior to close.<sup>125</sup> At the closing of the proposed transaction, Verizon will transfer to Frontier the functioning replicated operations support systems used by Verizon to serve its customers in Washington. According to Frontier, “the only impact to customers will be that the bills they receive for service will identify ‘Frontier’ as their service provider (versus Verizon as their previous provider).”<sup>126</sup>

74            Frontier will use and operate the replicated systems with more than 230 information technology personnel transferring to Frontier from Verizon who have experience in operating the OSS. Frontier has also negotiated an arrangement with Verizon whereby Frontier has the flexibility after the first year of a five-year agreement to purchase full, partial or no maintenance services for the transferred systems.<sup>127</sup> The total price for the services is \$94 million per year.

75            Frontier has no timeline for migrating services from the Verizon operations support systems to Frontier’s support systems utilized in the 24 states where Frontier currently operates. However, Frontier expects to realize integration savings in the first three years following the closing and part of this is from systems integration.<sup>128</sup> Frontier has committed that it at least will not complete any migration from or off of the replicated Verizon operations support systems to Frontier’s existing operations support platforms for a minimum of one year. Mr. McCarthy indicates that “Frontier intends to evaluate the functionality and features in serving customers, before making any definitive decision regarding the timing and implementation of the system integration. This measured approach that will rely on gaining experience with the systems

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<sup>125</sup> McCarthy, DM-8HCT at 42.

<sup>126</sup> McCarthy, DM-8HCT at 44.

<sup>127</sup> McCarthy, DM-8HCT at 43.

<sup>128</sup> “The realization of . . . annualized cost savings is expected to be achieved during the first two and a half years after the closing of the merger as the Spenco business’s network and information technology systems and processes are fully integrated with those of Frontier.” Frontier Form S-4, September 9, 2009, pp. 156-157.

before developing conversion plans and timelines should provide the Commission comfort that Frontier will not act hastily or without proper diligence.”<sup>129</sup>

76 Staff and Public Counsel expressed concern in testimony that Frontier could have some urgency to transition to its own systems soon after the first year based on the opportunity for potential synergies and the need to pay Verizon \$94 million per year for maintenance services associated with the replicated systems.<sup>130</sup>

77 With regard to the \$94 million maintenance fee, Frontier responded that “the sort of maintenance and support of software covered by the maintenance fee is a service that would have to be provided in any event, either through an outsourced third-party or additional internal employees.”

To be specific, the maintenance fee represents less than \$2.00 per line per month based on the over 4 million lines that are part of the proposed transaction. By contrast, based on FairPoint’s \$14.2 million monthly fee (using 1.528 million Verizon access lines acquired), the cost for FairPoint of the Transition Services Agreement with Verizon was approximately \$9.29 per line per month.<sup>131</sup>

Mr. Smith also cites to industry statistics for IT maintenance costs to illustrate that the Verizon maintenance fee for the transferred systems is in line with the industry average based on percentage of revenue.<sup>132</sup> This evidence convinces Staff that there probably will be no excessive urgency to convert systems following closing.

78 **Frontier’s Competence to Convert and Integrate Systems**—Finally, on the issue of OSS, Frontier presented evidence of its competence to convert and integrate acquired systems, including former GTE systems like those it is acquiring from Verizon.

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<sup>129</sup> McCarthy, DM-8HCT at 45.

<sup>130</sup> Roycroft TRR-1HCT at 36, 37.

<sup>131</sup> McCarthy, DM-8HCT at 48.

<sup>132</sup> Smith, SES-1T at fn. 28.

79            Frontier states that its legacy OSS have proven scalability and demonstrated capacity to absorb the VSTO operations.<sup>133</sup> Frontier also has an historical record to prove its ability to convert and integrate systems, which include order taking, billing, maintenance, and other operational support systems. Frontier has converted and integrated five billing systems successfully over the past five years, converting approximately 1.7 million access lines onto a single scalable company-wide platform.<sup>134</sup>

80            Frontier has completed many successful ILEC acquisitions and combinations over the last two decades, including several that involved Frontier (and its predecessors) and Verizon (and its predecessors). The company acquired more than 400,000 lines in 1999 through 2001 from GTE, and 1.1 million lines from Global Crossing in 2001. In fact, all of the 1.6 million lines Frontier purchased from GTE and Global Crossing in this time (with the exception of 62,200 GTE lines in Nebraska) closed from mid-2000 to mid-2001, more than doubling the size of the company over this period. Frontier has also acquired substantial properties since that time, including Commonwealth Telephone Enterprises (“Commonwealth”) which involved over 450,000 ILEC and edge-out competitive lines.<sup>135</sup>

81            In response to Staff and Public Counsel assertions that the transaction is much larger in scale than any previous transaction undertaken by Frontier, Frontier responded that the proposed transaction is large, but not unprecedented by any means.<sup>136</sup> The most comparable transaction is the slightly larger combination (in terms of total dollar value, target access lines to be acquired, and target states involved) of CenturyTel and Embarq, which the Commission recently approved.<sup>137</sup>

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<sup>133</sup> McCarthy, DM 27HCT at 44, 45.

<sup>134</sup> McCarthy, DM-8HCT at 58.

<sup>135</sup> McCarthy, DM-8HCT at 30, 31.

<sup>136</sup> Williamson, p. 12, lines 20-21, indicating that no company Frontier’s size has taken on a transaction as complex and large as this one.

<sup>137</sup> McCarthy, DM-8HCT at 31, 32.

**D. Staff, DoD/FEA, and CLEC Settlement Provisions are Adequate to Ensure No Net Harm**

82 The settlement agreement between Staff and the Joint Applicants is designed to achieve a number of public interest objectives. Some conditions are designed to mitigate potential harms such as rate increases or service quality problems that would not occur but for the transaction. Some conditions seek to ensure that Washington ratepayers receive the promised benefits of the transaction, primarily in terms of increased investment in broadband to preserve the revenue generating potential of telephone network. And some conditions, notably the financial reporting requirements, will provide the Commission with information it needs to understand the operating company's relationship with its new owner going forward. The settlement represents a balancing of these interests with Frontier's interest in not being overburdened by requirements that, in some cases, limit the company's flexibility in a time of great uncertainty in the ILEC industry. Because of this, it is somewhat unfair for Public Counsel to criticize particular elements of the settlement as being insufficient, particularly in the areas of high speed internet build-out commitments and service quality program enhancements, both of which represent positive benefits over the status quo with Verizon as owner.

83 Staff views the various competitive local exchange carrier (CLEC) settlement agreements as complimentary to Staff's settlement with the company. The CLECs are best aware of their needs with respect to the ILEC's provisioning of wholesale services and honoring of interconnection agreements. The preservation and advancement of vigorous intra-modal (wireline) competition has long been a public interest goal and Staff believes the conditions contained in the various CLEC agreements serve that goal.

84 The Joint Applicants' settlement with DoD/FEA was executed after Staff's agreement with the Applicants and builds on two aspects of the Staff settlement. It extends the three year residential rate cap to business class rates and it builds on the service quality program in the Staff

settlement by requiring more frequent reports and a requirement for Frontier to prepare budgets to correct any service quality problems that arise. Staff finds these to be welcome additions to the framework of its settlement with the Applicants.

85 At the hearing in this case, Public Counsel presented the testimony of its witnesses in opposition to the Staff settlement while Staff and the Joint Applicant witnesses stood cross examination on their pre-filed testimony in support of the settlement and presented oral surrebuttal.

86 Presented in this Section IV.C is a description of the terms of the settlement between Staff and the Joint Applicants, including Staff's response to Public Counsel's criticisms and argument for additional conditions. For ease of understanding, the conditions are grouped somewhat differently than they are presented in Attachment 1 to the Settlement Agreement, as follows:

- Notification of Material Changes to Transaction (Condition 9)
- Provisions to Ensure No Harm Related To Retail Rates and Services (Conditions 4, 5, 11, 22-26, 32-35)
- Earnings Review and AFOR (Condition 2)
- Reporting Provisions (Conditions 1, 3, 6, 7, 8, 10, 12)
- Broadband Benefit Commitments (Conditions 13-18)
- Retail Service Quality (Conditions 19-21)
- Operations Support Systems (Conditions 27-31)
- Public Counsel Recommendations Outside the Scope of the Staff and DoD/FEA Settlements

The final bullet point includes Staff's response to Public Counsel's argument that the "Required Payment Provision" (or in Public Counsel's description, the "regulatory claw back" provision) of the Merger Agreement is contrary to the public interest.

87 Please note that in the discussion below, the settlement conditions are paraphrased instead of being set out verbatim.



### **Notification of Material Changes to Transaction**

88 Assuming the Commission were to approve the proposed transaction, there would be a period of time between the Commission's order and the actual close of the transaction in which material terms of the transaction could change. Therefore, the settlement includes the following condition to assure that the Commission is at least notified of changed terms or conditions:

- **The Joint Applicants will notify the Commission of any material change to the transaction terms and conditions between the approval of the merger and the close date. (Condition 9)**

Upon notification, the Commission has authority to change or revisit its order of approval under RCW 80.04.210.

89 This condition is consistent with Dr. Roycroft's recommendation that, "as a preliminary requirement to enable even the conditional approval of the merger, Frontier should demonstrate to the Commission that it has not financed the new debt at a rate above 9.5 percent. Once Frontier secures the necessary debt financing for this transaction, it should file a report summarizing the results with the Commission."<sup>138</sup>

90 Staff believes that a debt issuance at a rate exceeding 9.5 percent would trigger this condition of the settlement agreement requiring Commission notification and potential re-evaluation. As noted above, Frontier is not obligated to close the transaction if it cannot obtain financing at 9.5 percent or better.

### **Provisions to Ensure No Harm Related To Retail Rates and Services**

91 A number of conditions of the settlement are designed to prevent specific harms that could otherwise result to retail consumers of the operating company's regulated services as a consequence of the merger. Those conditions are as follows:

- **Frontier will not seek to recover branding and transition costs from the Washington customers. (Condition 4)**

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<sup>138</sup> Roycroft, TRR-1HCT at 91.

- **Frontier will not encumber Frontier NW assets. (Condition 5)**
- **Frontier NW will hold retail and wholesale customers harmless for increases in overall management costs that result from the transaction. (Condition 11)**
- **Frontier agrees to continue the imputation associated with the spin-off of Verizon’s yellow page business in Docket UT-061777. (Condition 22)**
- **Frontier NW may not increase its residential flat and measured rate for a period of three years. The Company may petition the Commission to seek a rate increase if such an increase is made necessary by material exogenous events such as FCC or Commission access charge reforms. (Condition 23)**
- **The Company will continue to provide “grandfathered” services to existing Verizon customers for at least six months from the transaction close date. (Condition 24)**
- **Frontier must waive the Primary Interexchange Carrier non-recurring charge for any transitioned Verizon NW intrastate long distance customer requesting a change to another long distance service provider for a period of 90 days after the transaction close date. (Condition 25)**
- **Frontier will continue to offer bundled services for a minimum of 12 months following the date of close. (Condition 26)**
- **Frontier NW will provide a one-time \$75 credit to any WTAP-qualified customer that fails to receive the appropriate discount or credit in the first possible billing cycle after a verified application. (Condition 32)**
- **Frontier NW will make monthly reports containing agreed upon WTAP data to Commission Staff. (Condition 33)**
- **Frontier NW will provide clear scripts to its customer service and sales representatives so that customers are aware that WTAP rates are not available on bundled services. (Condition 34)**
- **Frontier NW will verify customer eligibility for WTAP by a three-way call to DSHS during the agency’s business hours. (Condition 35)**

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Public Counsel questions the need for Condition 5 based on Mr. Hill’s assertion that telecommunications companies do not encumber property as a means of securing debt, but instead provide debentures. Staff included this condition based on concerns about what the covenants might be for the \$3.3 billion that Frontier must borrow for the transaction. Mr.

Whitehouse testified that Mr. Hill is incorrect and that not agreeing to a mortgage or pledge of ILEC assets in return for a cheaper lending rate is a real benefit to the public.<sup>139</sup>

93 Public Counsel next takes issue with the protections afforded to customers who currently purchase bundles of services—i.e., specially priced offers that include both regulated and unregulated services such as local, long distance, calling features, and high speed internet. Public Counsel is concerned that upon the expiration of Condition 26 (requiring Frontier to continue to offer Verizon’s bundles for 12 months) prices could increase for these offerings.<sup>140</sup> Staff agrees that this is a possibility. However, Staff believes that competitive pressures tend to constrain prices of unregulated services. To the extent that customers wish to return to purchasing regulated services on an a la carte basis from the tariff, they are free to do so.

94 Dr. Roycroft also asserts that there should be a provision in the settlement that allows current Verizon customers who are on term contracts for bundled services (e.g., for one year) to be afforded a chance to break that contract when Frontier takes it over from Verizon, without incurring the contract’s termination fee.<sup>141</sup> This is similar to a recommendation made by Staff in pre-filed testimony.<sup>142</sup> Frontier indicates that it has committed to honoring any customer contracts that are in place for the duration of the contract. Therefore, there is no reason to waive early termination fees, since customers will continue to receive the same service, using the same facilities, that they were receiving from Verizon prior to the transaction.<sup>143</sup> As a general pricing scheme, term contracts spread what would otherwise be high connection charges over the term of the contract. Staff was willing to compromise on this condition, recognizing that if Frontier’s

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<sup>139</sup> TR. 491.

<sup>140</sup> TR. 287:20-23.

<sup>141</sup> TR. 462.

<sup>142</sup> Roth, JYR-1HCT at 11.

<sup>143</sup> McCarthy, DM-8HCT at 73.

practices with regard to term contracts were to be anticompetitive in any way, that would properly be addressed under the Consumer Protection Act.

### **Earnings Review and AFOR**

95 Condition 2 combines a protective element regarding an earnings review (including an appropriate cost of capital) with a requirement that Frontier file for an alternative form of regulation within five years.

- **Frontier Northwest (Frontier NW – the name to be given the local operating company now known as Verizon Northwest) will file results of operations, an alternative form or regulation (AFOR) proposal and cost of capital will be based upon “investment grade” debt and equity. (Condition 2)**

At hearing, Commissioner Oshie asked for clarification of why Staff has included a requirement for Frontier to file for an AFOR.<sup>144</sup> The point of requiring an AFOR *with a full earnings review* by a date certain is to set an appropriate form of regulation for the Company (that will likely include a rate cap) based on a full audit of the Company’s earnings once the “dust has settled” on this transaction and the overall Company synergies are realized.

96 The focus is more on the full audit than on the AFOR as such. The reason that Staff uses the AFOR rather than a general rate case filing as the vehicle for the earnings review is because Staff believes that all of the larger telecommunications companies in Washington should move toward an AFOR for policy reasons having to do with competition and the declining relevance of the regulatory model that was developed for a significantly less competitive market than exists today.

97 Dr. Roycroft testified for Public Counsel that “whether or not there would be any benefit for customers from an AFOR it’s difficult to say, but certainly I’ve seen AFORs that have resulted in harm to consumers.”<sup>145</sup> There is nothing in the settlement however, that requires the

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<sup>144</sup> TR. 330.

<sup>145</sup> TR. 466.

Commission to accept the AFOR at all, let alone on the conditions that Frontier might propose. The terms of the AFOR, or whether to grant one at all, remain fully within the Commission's discretion.<sup>146</sup>

98 Chairman Goltz asked how customers would continue to get the benefit of the imputation of the Yellow Pages gain if the company filed for an AFOR, assuming it continues through 2015.<sup>147</sup> Mr. Weinman explained that in the AFOR filing, the company would have to file complete results of operations and that these will include imputation of the Yellow Page gain.<sup>148</sup> Ms. Russell's testimony explains that the effect of the imputation is \$37.5 million annually, and \$6 per month per customer.<sup>149</sup>

### **Reporting Provisions**

99 The settlement includes a number of information reporting commitments on the part of Frontier.

- **Frontier will file quarterly reports listing intercompany receivables and payables balances and activity between Frontier and Frontier NW. Dividends declared by Frontier NW to the parent will also be included in this report. (Condition 1)**
- **Frontier will provide bi-annual reports of synergy savings. (Condition 3)**
- **Frontier will furnish Staff with post-transaction financial data. (Condition 6)**
- **The Company will report the annual expenditures between Verizon and Frontier for transitional services (such as Verizon provision of OSS maintenance services on behalf of Frontier). (Condition 7)**
- **Frontier will comply with affiliated interest transaction filings under WAC 480-120-375. (Condition 8)**
- **Frontier NW will maintain its books and records to enable the Company to report Washington-specific financial data. (Condition 10)**

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<sup>146</sup> RCW 80.16.020.

<sup>147</sup> TR. 355.

<sup>148</sup> TR. 356.

<sup>149</sup> TR. 393.

- **Frontier will submit a multi-year strategic plan identifying the expected remaining life and replacement of Washington host and remote central offices. (Condition 12)**

100 Public Counsel’s financial witness, Stephen Hill addressed the “financial” conditions of the settlement (Conditions 1-12) including the reporting requirements listed above. In general, Mr. Hill did not object to the conditions or take issue with the usefulness of the information. Instead, he said that the requirements were not substantive enough to address concerns about wealth transfers away from the operating company.<sup>150</sup>

101 Intercompany receivables and payables fall under the rubric of “affiliated interest transactions.”<sup>151</sup> The reasonableness of costs associated with transactions the regulated company has with its affiliates ordinarily becomes an issue in a rate case, and it would also be an issue in the earnings review that Frontier has committed to file in connection with its AFOR filing. In setting rates (or in designing a rate cap or similar mechanism under an AFOR) the Commission may disallow costs associated with affiliated interest transactions to the extent that they exceed a reasonable amount (the lower of cost or fair market value).

102 Staff’s view is that the possibility of a wealth transfer away from the operating company (if such a possibility even exists in this case) is significantly reduced by Frontier’s commitment to place \$40 million in escrow and to commit to significant and costly expansion of broadband on its network in Washington (Conditions 13-17 below). One way to try to assure that a company will invest in the network and build broadband infrastructure is to try to restrict dividends or cash flow to the parent so that the company must retain earnings. A more direct approach is to require the company to meet increased broadband availability levels over time and to provide a financial incentive for it to do so. That is the approach taken by the settlement.<sup>152</sup>

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<sup>150</sup> TR, 429-435.

<sup>151</sup> See RCW 80.16.

<sup>152</sup> Weinman, TR, 324, 25.

103           The purpose of these reports is in part to keep Staff informed of what is occurring with dividends from Frontier NW to the parent. Any large changes in intercompany accounts will allow Staff to monitor the balances and request information from Frontier about the change to the accounts. Should the reports raise a concern, the Commission has authority to restrict unreasonable company practices—such as a practice of excessive dividends that prevents necessary maintenance or investment—after notice and hearing under RCW 80.36.140 (2<sup>nd</sup> paragraph).

104           Regarding Condition 3 (report of synergy savings), Staff was initially skeptical of Frontier’s ability to achieve synergies based on improved economies of scale for the benefit of Verizon Northwest, because that business will become part of a smaller company. However, Frontier asserts that it believes it can do things more efficiently than Verizon and actually achieve lower overhead compared with the Verizon organization.<sup>153</sup> Therefore, it is appropriate to track those synergies, as was done under the CenturyTel/Embarq settlement so that they can be captured in a later rate proceeding or AFOR.

105           Chairman Goltz asked if one condition should be to require Frontier to submit a budget in response to Public Counsel’s concern about the lack of a capital budget for Washington at this stage in the transaction from Frontier.<sup>154</sup> It appears that Public Counsel points to the lack of such a budget at this stage of the transaction as evidence of Frontier’s lack of fitness or seriousness about building out broadband in Washington. Frontier, on the other hand, asserts that it is unrealistic to expect a purchaser to have developed the kind of detailed, state by state capital construction project planning that a budget entails before it even owns the business.<sup>155</sup> Staff agrees that having a detailed state-specific capital projects budget developed at this point is

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<sup>153</sup> McCarthy, TR. 357, 358.

<sup>154</sup> TR. 363.

<sup>155</sup> TR. 378.

unrealistic. As to Frontier's commitment to capital improvements that benefit the Washington network and Washington consumers, that is the purpose of the very specific broadband deployment plan called for by Condition 17 and the specific availability and speed commitments of Conditions 15 and 16 (discussed below). The \$40 million escrow provides further assurance that the funds will be committed for these projects and that Frontier will have the incentive to do the projects and report regularly on its progress.

### **Broadband Benefit Commitments**

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As discussed above, Staff believes that Frontier's objective to expand the ability of the Washington telephone plant to provide broadband service to a greater percentage of customers is in the public interest because it will provide revenue to offset the cost of facilities shared with regulated services. From Staff's perspective, it was important to get specific commitments from the company to help ensure that its promises with regard to broadband expansion are realized.

Those commitments are as follows:

- **Frontier will fund a \$40 million dollar escrow account for broadband deployment. (Condition 13)**
- **If Frontier NW determines that it is technically infeasible to fulfill one or more of the objectives in conditions 15 through 18, it will submit a detailed report to the Commission describing the problems and propose a plan that provides at least a similar level of public benefit. (Condition 14)**
- **Frontier NW must deploy broadband service in not less than 95 percent of the wire centers within two years and make broadband available to approximately 89 percent of the households by December 31, 2014, with specific commitments to unserved wire centers. (Condition 15)**
- **Frontier must achieve specified upload and download speeds for the broadband service it deploys. (Condition 16)**
- **Frontier NW must submit an initial plan for broadband deployment within 90 days of the transaction closing date. (Condition 17)**
- **Frontier NW must make stand-alone DSL available to consumers for 12 months after the closing of the transaction. (Condition 18)**



Dr. Roycroft argues that the broadband buildout promises of Frontier are not a genuine benefit for two reasons. First, he implies that if Verizon retained ownership of Verizon Northwest, it would continue to build out its FiOS fiber-to-the-home footprint beyond its current franchise commitments in Washington.<sup>156</sup> Second, he implies that Frontier is using an inferior type of broadband technology that is somehow inconsistent with an incremental approach to broadband expansion.<sup>157</sup> Neither of Dr. Roycroft's assertions is supported by evidence and is contrary to the record. In fact, Verizon has no plans to continue FiOS expansion in Washington beyond its current franchise commitments.<sup>158</sup> In contrast, Frontier's plan is to extend broadband capacity at modest speeds to as large a percentage of customers as is feasible, and then to incrementally increase speeds by pushing more fiber capacity out into the network (i.e., through the "middle mile" and ultimately all the way to the home or business).<sup>159</sup>

There was much discussion at hearing about administration of the \$40 million escrow account described in Condition 13. Mr. McCarthy clarified that "it would be set up as an irrevocable escrow account where we would set up the instructions with a third party escrow agent only to allow disbursement back to Frontier based upon written instructions from the Commission that it was satisfied that we had met the requirements of the broadband buildout for that period."<sup>160</sup> Frontier would absorb all of the costs associated with establishing the account and paying an escrow agent to monitor the funds. Frontier would set the account up with cash on hand at closing.<sup>161</sup>

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<sup>156</sup> TR. 446-47; 457.

<sup>157</sup> TR. 448.

<sup>158</sup> TM-11, which is a DR response says: "Verizon has not targeted investment in Washington for broadband deployment except where it has [an] existing, unfulfilled obligation to deploy FiOS."

<sup>159</sup> McCarthy, TR. 499.

<sup>160</sup> TR. 386.

<sup>161</sup> *Id.*

Dr. Roycroft argues that a problem with the \$40 million escrow account is that there may be factual disputes—presumably when Frontier seeks to release funds upon completion of broadband construction work under Condition 13—regarding whether the work was done for the purpose of bringing broadband to an area or just to remedy problems with the voice service.<sup>162</sup> This is a misplaced concern in Staff’s view. First, the company is required to achieve the specific broadband availability requirements identified in Conditions 15-17 regardless of whether the cost is greater or less than \$40 million. The \$40 million escrow simply provides an assurance that the amount of money that is estimated for the projects is actually set aside, and to give the company an incentive to pursue the specific availability percentages and network speeds expeditiously. Second, under Condition 17, Frontier must submit a plan within 90 days of closing on how it intends to meet the buildout requirements of Conditions 15-17. Therefore, Staff does not foresee any opportunity for Frontier to try to draw down the \$40 million through reimbursement requests for work that is not identified in the plan and tied to the specific expansion requirements of Conditions 15-17.

Roycroft also faults the broadband conditions for not requiring that any Federal broadband stimulus funding be used for projects that are in addition to the commitments in the settlement, rather than going toward the achievement of the build-out percentages and speeds.<sup>163</sup> In Staff’s view, the point of the conditions is not to force the company to spend \$40 million on broadband, but to achieve specific benchmarks. If the company can obtain grant money for this purpose, so much the better. In any event, Mr. McCarthy indicates that the final five to seven percent is the target segment for stimulus funding.<sup>164</sup>

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<sup>162</sup> TR. 449-50.

<sup>163</sup> TR. 452-53.

<sup>164</sup> TR. 502.

109 Another fault with the \$40 million escrow, according to Roycroft, is that fiber to the home deployments are excluded.<sup>165</sup> However, Roycroft himself notes that the reason is to segregate this fund from monies that will be used to complete the FiOS buildout.

110 Roycroft pushes the idea that some amount of the company's projected synergies should be identified and used as a basis for requiring even more broadband buildout.<sup>166</sup> This suggestion is ironic given the Public Counsel witnesses' extreme skepticism regarding Frontier's financial fitness and ability to meet the projections of its financial model. It is inconsistent for Public Counsel to argue on the one hand that Frontier is financially feeble and that the transaction should not be approved, but then to force investments, beyond what Frontier has agreed is achievable, based on the expectation of overearnings in future years as a result of improved efficiencies.

111 Roycroft also generally takes issue with the broadband availability percentages, the timeline for achieving the objectives, and the download and upload speed objectives.<sup>167</sup> Staff believes these are unfair criticisms because the settlement is a package that includes give and take on numerous conditions, many of which impose costs on the company. Moreover, it was not Staff's intention to require the company to build out to an extent that it could not justify from a return on investment standpoint.<sup>168</sup> Rather, it was Staff's intention to have Frontier flesh out what it means when it says it has a business plan to expand broadband availability, and to ensure that Washington consumers actually receive that positive benefit as a result of this transaction. As Dr. Roycroft himself said in pre-filed testimony, "[t]he lack of specific commitments or details regarding Frontier's plans for broadband deployment in Washington leaves the

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<sup>165</sup> TR. 453.

<sup>166</sup> TR. 454.

<sup>167</sup> TR. 456-58.

<sup>168</sup> Mr. Weinman stated on cross that "once you get to 90%, I believe the rest of the buildout of 10% is extremely difficult to justify economically." TR. 280:11-13.

Commission with no basis for determining whether broadband benefits can be counted in the evaluation of benefits and costs associated with this merger.”<sup>169</sup> These conditions remedy that deficiency.

112 Finally, Dr. Roycroft makes various recommendations that the Commission cap the rates and otherwise manage the terms of Frontier’s high speed internet service because of what he views as high prices and onerous usage restrictions on Frontier’s unregulated broadband services.<sup>170</sup> Staff believes these proposals go too far afield from the Commission’s regulatory authority over voice telecommunications services. Broadband is a benefit to voice customers because it provides revenue to offset the cost of shared facilities—the Commission lacks regulatory authority of internet access services as such.

### **Retail Service Quality**

113 The retail service quality provisions provide assurance that the local exchange Company’s basic service quality metrics will not deteriorate following the transaction. They augment the Commission’s existing service quality rules which are enforceable with penalties.<sup>171</sup>

- **Frontier NW will adopt Verizon’s Service Performance Guarantee (SPG) standards and has agreed to increase the amount for the residential missed commitment credit from \$25.00 to \$35.00 for missed commitments. Frontier will also provide an out of service credit of \$5.00 for service outages lasting more than two days. (Condition 19)**
- **Frontier has also agreed to a service quality program, based on six service quality metrics, which would distribute customer credits each month up to an annual amount of \$100,000 (\$100,000/12) for each missed metric. This provision also contains an escalator providing an additional credit of \$100,000 for the second year of each missed metric and another \$200,000 escalator if the metric is missed in all three years. (Condition 20)**
- **The Company will also provide an annual report card of these metrics to their customers and to the Commission. (Condition 21)**

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<sup>169</sup> Roycroft TRR-1HCT at 74.

<sup>170</sup> TR. 458-60.

<sup>171</sup> See Russell, KMR-3.

Condition 19 concerns the Verizon Service Performance Guarantee (SPG) program that is currently offered by Verizon and which Frontier has committed to retain. The condition requires Frontier to increase the credit that residential customers receive for missed commitments from \$25 to \$35. Other enhancements are provided as well. Ms. Alexander criticizes this increase in the Service Performance Guarantee program on the basis that it would have had a financial impact on Verizon, if applied over the past year, that Ms. Alexander describes as miniscule.<sup>172</sup> Ms. Alexander also asserts that the increased SPG credits in Condition 19 should not be removed after 24 months but instead should be tied to when the migration to Frontier systems after close takes place.<sup>173</sup> Condition 19 provides that the company may petition to remove the increase SPG conditions after 24 months. Ms. Alexander’s criticisms of the SPG enhancements are puzzling, because it was not Staff’s intent, nor is it apparently hers, to remedy an existing Verizon problem with missed commitments. Rather, the provision seeks to establish a customer benefit to offset harms that may exist as a result of the transaction.

114

Condition 20 establishes a service quality program, based on six service quality standards, which would require Frontier to distribute bill credits for each monthly or annual period in which the company misses a standard during the three years following the merger. Public Counsel witness Barbara Alexander criticizes this provision primarily on the grounds that four of the six metrics borrow the standards in the Commission’s existing service quality rules.<sup>174</sup> As such, they do not, in her view, “prevent deterioration in performance where that performance by Verizon is already better than the minimum standards in the Commission’s regulations.”<sup>175</sup> Also, Ms. Alexander believes the amount in jeopardy is not sufficient to “have

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<sup>172</sup> TR. 407, 408.

<sup>173</sup> TR. 305, 306; TR. 413.

<sup>174</sup> TR. 409.

<sup>175</sup> TR. 406.

any significant impact on the company or its shareholders....”<sup>176</sup> Public Counsel also asserts that total amount in jeopardy is only 12% of what Staff originally recommended in testimony.<sup>177</sup>

115 As explained by Mr. Weinman, the Condition 20 program is three years because it was intended to cover the likely transition period in which the company might experience some urgency to convert from Verizon’s operations support systems to the Frontier systems.<sup>178</sup> Staff agrees that the integration of systems could occur outside that period but by that time the operations people should be “in tune” with their new territories.<sup>179</sup>

116 Because of an acceleration mechanism that applies in the case of repeated misses year-to-year, the actual amount in jeopardy in year one is \$600,000, year two is \$1.2 million, and year three is \$1.8 million, for a total of \$3.6 million over three years.<sup>180</sup> Staff believes this amount is significant enough to provide an incentive to maintain good service quality while being fair to the company.<sup>181</sup> Because the origin of this provision was a program previously imposed by the Commission on Qwest, Commissioner Oshie asked why Qwest was in jeopardy for a great deal more in credits than Staff proposes for Frontier in this case.<sup>182</sup> Mr. Weinman explained that Qwest was demonstrably suffering from poor service quality. By comparison, we have no reason to believe that Frontier is providing poor service quality and Verizon trouble indexes are low suggesting that the outside plant in good condition.<sup>183</sup> At the time Staff filed its written testimony, FCC ARMIS data led Staff to believe that Frontier might have lower service quality than Verizon in certain measures.<sup>184</sup> However, on rebuttal, Frontier witness Billy Jack Gregg explained that, because of differences in the way Frontier reports to the FCC, Frontier’s ARMIS

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<sup>176</sup> TR. 411.

<sup>177</sup> TR. 307, 308.

<sup>178</sup> TR. 310.

<sup>179</sup> *Id.*

<sup>180</sup> TR. 387.

<sup>181</sup> Weinman, TR. 308.

<sup>182</sup> TR. 341.

<sup>183</sup> TR. 392.

<sup>184</sup> Russell, KMR-1T at 11-20.

service quality data appear to be worse with respect to regulated services than is in fact the case.<sup>185</sup> No state Commissions or Staffs indicate a problem with Frontier's service quality.<sup>186</sup> Therefore, the program is not remedial, as Qwest's program was. Rather, it is partly precautionary, and partly an attempt to provide Washington customers a positive benefit from the merger in the form of improved service quality incentives for the new company. In addition, there are penalties under the Commission's rules for failure to meet service quality standards which were not in place when Qwest got into service quality problems.<sup>187</sup> This program would be on top of the service quality rules that were inspired by Qwest's service quality problems. In addition, the DoD/FEA settlement adds an additional requirement that the company must establish a budget to fix missed service quality metrics.<sup>188</sup>

### **Operations Support Systems**

117

In order to address the potential for service quality problems arising from possible difficulties with (1) the replication of Verizon's operations support systems (OSS) prior to the close of the merger and (2) with possible migration in following years from Verizon systems to Frontier's own OSS, the settlement includes the following provisions:

- **Verizon must replicate the existing Verizon OSS for both retail and wholesale operations. Verizon must put into production the replicated systems at least 60 days prior to the transaction close date. Verizon will engage a neutral third party reviewer acceptable to Verizon and Commission Staff. (Condition 27)**
- **The Joint Applicants may not proceed with closing until each company has validated that OSS systems are fully functional. (Condition 28)**
- **For three years after closing, Frontier NW will report any plans to transition Verizon OSS to Frontier legacy systems. (Condition 29)**
- **Frontier will give notice at least 180 days before it transitions any replicated OSS systems supporting wholesale operations. (Condition 30)**

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<sup>185</sup> Gregg, BJG-10T at 5-12.

<sup>186</sup> TR. 392.

<sup>187</sup> TR. 391, 92.

<sup>188</sup> TR. 391, 92.

- **Frontier NW must maintain functionality performance and e-bonding at a level that is at least equal to Verizon’s current performance. (Condition 31)**

Public Counsel has numerous criticisms of the settlement’s OSS provisions, focused primarily on

Conditions 27 and 28:

- 60 days of testing is not long enough to determine whether the replicated systems are operating as intended.
- Only four service quality metrics are used and not all of those in Staff’s Condition 20.
- One of the service quality metrics concerning “billing error complaints” is not defined.<sup>189</sup>
- Staff and the Commission will only have five days to review the report prior to close.<sup>190</sup>
- No process is spelled out in the agreement for what should happen during the five days in the event of a disagreement as to whether there has been a material degradation of service quality on the replicated systems.<sup>191</sup>
- There is no definition of “material degradation.”<sup>192</sup>

In considering these Public Counsel concerns, it is important to realize that Frontier has a critical business interest in ensuring that Verizon correctly replicates its operational support systems for delivery to Frontier. Frontier will itself undertake a detailed review and ongoing efforts to ensure that the replicated wholesale systems are working properly and will not proceed with closing of the proposed transaction unless and until the operational support systems are fully functioning and operational.<sup>193</sup>

118 As to the adequacy of 60 days for testing, Staff believes it is sufficient to capture one full billing cycle and to allow for determination of errors that would likely arise immediately.

119 Staff believes that the four metrics are those that would be most indicative of the kind of problems that arose in past OSS cutover failures.<sup>194</sup>

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<sup>189</sup> TR. 289-295; TR. 414.

<sup>190</sup> TR. 295. TR. 414.

<sup>191</sup> TR. 295, 296.

<sup>192</sup> TR. 297, 298.

<sup>193</sup> McCarthy, DM-8HCT at 86.

<sup>194</sup> TR. 297.



120 While it is true that it may be difficult to define a “billing error,” the receipt by the company of a customer *complaint* pertaining to an error in that customer’s bill is not ambiguous, in Staff’s view. Moreover, while the parties all acknowledge that billing errors were a symptom of the systems conversion failures in the Hawaiian Tel and FairPoint transactions, Ms. Alexander does not offer any alternative means for defining the term or monitoring the problem.<sup>195</sup>

121 Regarding the five day period in which Staff reviews the results of testing prior to close, Staff will be dealing with companies during the 60 days as well as with Staffs in Oregon and Ohio who have similar conditions. Also, the third party reviewer will be involved in testing during those 60 days.<sup>196</sup> Although the third party reviewer is only listed in reference to the tests in Condition 27, the third party reviewer will also validate the metrics in Condition 28.<sup>197</sup> The reviewer does not simply validate the accuracy of the data, but “that the test plan as written by Verizon and the test scripts that are being used are the correct types of tests to run and that the answer to those tests is accurate.”<sup>198</sup> Staff expects to see reports from the third party reviewer prior to the five days.

122 Whether there has been a “material degradation” in the service quality measures is admittedly somewhat subjective, but Staff believes that any problems that are symptomatic of an OSS failure would be readily apparent, would happen immediately, and is unlikely to be very subtle.

123 Finally, Staff believes it has legal mechanism to bring the matter before the Commission if there is a dispute as to whether the systems are functioning properly.<sup>199</sup>

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<sup>195</sup> TR. 416, 17.

<sup>196</sup> TR. 296, 97.

<sup>197</sup> Williamson, TR 302; McCallion, TR 376, 377.

<sup>198</sup> Williamson, TR. 301.

<sup>199</sup> TR. 298;WHW-38.

## **Public Counsel Recommendations Outside the Scope of the Staff and DoD/FEA Settlements**

- **Mr. Hill's Recommended Dividend Restriction at the Parent Level**

124           Based on concerns with Frontier's dividend policy, discussed previously, Mr. Hill proposes that Frontier, the parent company, be required to limit its dividends to shareholders to its net earnings. At hearing he stated "this requirement that they limit their dividends is a little more heavy handed, but basically it goes after the same thing, trying to retain money in this local operation so we can have some local input to the capital needs. That's the idea, which is kind of the same as [Conditions 1-12], but it's a different way to get about it."<sup>200</sup>

125           In Staff's view Mr. Hill's proposed dividend restriction is indeed heavy handed and not well considered. It applies to the Frontier parent company as a whole and is in no way limited to Washington jurisdictional operations or even to the regulated public service company. Second, it would plainly have very undesirable consequences. Frontier Treasurer David Whitehouse stated in response to the proposal that "[a]ny condition that is likely to limit or put at substantial risk the predictability and sustainability of the parent company dividend might dramatically reduce the value of that dividend stream to investors, causing a corresponding decline in Frontier's equity value. The net effect of a limitation on dividends would be to impair severely the company's ability to attract competitively priced equity capital. The result of this condition is entirely predictable, which is to make Frontier's equity more costly (because the increased risk to dividends will have to be factored into the security)."<sup>201</sup> Even Public Counsel witness Dr. Roycroft recognizes the peril of a sudden reduction of dividends, stating that, if

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<sup>200</sup> TR. 435-36.

<sup>201</sup> DW-1T at 58.

Frontier “decreases its dividend further, its stock price will fall, and it could become overleveraged, thus undermining the gains it may achieve from executing this transaction.”<sup>202</sup>

- **Mr. Hill’s Recommended Refund of \$600 million of purchase price from Verizon to Frontier**

126

Mr. Hill recommends that Verizon be required to essentially reduce the price of the VSTO properties to Frontier by \$600 million (\$70 million on a Washington basis).<sup>203</sup> As discussed in Section IV.B.2, above, there is no evidence in the record to rebut the presumption that the terms of the merger agreement were negotiated at arm’s length by a knowledgeable and experienced buyer based on accurate financial information. As such, there would be no basis to attempt to change the price term of the merger as a condition of approval.

- **Dr. Roycroft’s Recommended Warranty for the Condition of Outside Plant**

127

Based on his assertion that Frontier did not adequately inspect the VSTO outside plant and that the plant may be in worse condition than Frontier expects, Dr. Roycroft proposes that the Commission require Verizon to provide a \$40 million fund to insure the condition of outside plant in Washington.<sup>204</sup> Staff believes this condition is unnecessary because Frontier is a knowledgeable acquirer of ILEC properties and has investigated the condition of the outside plant that it negotiated to purchase from Verizon. As discussed in Section IV.B.2, above, there is no reason to believe that the condition of the outside plant in Washington is other than as expected when Frontier and Verizon executed the merger agreement. Another problem with this proposal is that there is no benchmark against which to measure what might represent a “problem” with the condition of the outside plant or whether the condition of the plant is other than Frontier should reasonably have expected.

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<sup>202</sup> Roycroft TRR-1HCT at 60.

<sup>203</sup> Hill, SGH-HCT at 50, TR. 436.

<sup>204</sup> Roycroft, TRR-1HCT at 96; TR. 446.

- **Mr. Hill’s Suggestion of a Separate Washington Corporation**

128 During his oral testimony in opposition to the settlement, Mr. Hill off-handedly suggested that the Commission should require Frontier to form a separate corporation for the state of Washington, apparently as a means of achieving ring fencing of the Washington operations.<sup>205</sup> Staff believes this is an extremely ill-conceived idea. Verizon Northwest is already a separate corporate entity, incorporated in the state of Washington, that operates in three states: Oregon, Idaho and Washington. There is no concern from any party about allocations or cash flows among the three states in Verizon Northwest’s territory. Therefore, requiring Verizon Northwest to form even smaller, state-specific corporate entities would serve no purpose. It is the affiliated interest transactions between the parent and the operating company that Staff seeks to monitor with the various reporting conditions in the settlement, not *intra*-company allocations among the operations in the three states.

129 If Mr. Hill’s suggestion is to set up a corporation that is sufficiently autonomous and self-sustaining to meet the requirements of a bankruptcy court for being firewalled off from any Chapter 11 reorganization involving the parent, then a great deal more would be required than simply forming a separate corporation for the state of Washington. The organizational changes that would be required could be extremely costly for Washington ratepayers in terms of additional overhead costs and lost economies of scale from having a truly separate business entity operating within the state of Washington.<sup>206</sup>

- **Mr. Hill’s Criticisms of the “Required Payment Amount” Provision**

130 As part of their recommended conditions involving the transfer of monies from Verizon back to Frontier, Public Counsel asked the Commission to require that Verizon and Frontier alter

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<sup>205</sup> TR. 434.

<sup>206</sup> TR. 514-17.

a provision in the merger agreement providing that if costs are imposed on Verizon by a regulatory body, then that will increase the number of shares of Frontier stock that Verizon shareholders receive in the transaction (Sections 1.167 and 1.144 of the Agreement and Plan of Merger).

131           This provision is not a concern for Staff because Staff has not sought to impose any requirements on the seller, Verizon, except for those related to third party review of the testing of the replicated operations support systems prior to close. Verizon has said it will pay for this third party reviewer because it is related to the cost of systems replication that Verizon assumed under the merger agreement.<sup>207</sup> Verizon confirmed it is absorbing that cost of between half a million dollars and \$1 million.<sup>208</sup>

132           In response to testimony from Mr. Hill suggesting that there may be something contrary to public policy in such a provision, Chairman Goltz asked parties to address the issue. In Staff's view, the issue is a red herring. So long as a state commission has appropriate authority and substantial evidence that harm would result to the public interest from a proposed transaction, it can either (1) reject the transaction, or (2) approve the transaction on the condition that parties agree to voluntarily undertake whatever commitments the commission finds necessary to mitigate the harm. In this case, Mr. Hill recommends that the Commission take the extraordinary and, as far as Staff is aware, unprecedented action of conditioning its approval of the transaction on one party giving back to the other a portion of the compensation that it has negotiated for its property. Through the lens of this unusual recommendation, Mr. Hill believes that he has discovered a provision in the Agreement and Plan of Merger that is designed to foil his recommendation. Staff believes this a distortion. The provision merely gives existing Verizon

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<sup>207</sup> *Id.*

<sup>208</sup> TR. 397, 98.

shareholders more ownership (shares) in the combined Frontier company to the extent that Verizon is required to expend money on regulatory requirements. Moreover, there is no provision in a merger agreement, including this one, that the Commission could not insist that the parties change or renegotiate if the evidence showed that the provision would harm the public interest. Thus, there is no reason for this Commission to view this provision as an affront to its authority.

#### IV. CONCLUSION

133 For the foregoing reasons, Commission Staff recommends that the Commission approve the proposed transaction, subject to the conditions set forth in the settlement agreement between Staff and the Joint Applicants, the settlement between the Joint Applicants and DoD/FEA, and the various settlements between the Joint Applicants and the CLEC interveners.

DATED this \_\_\_\_ day of \_\_\_\_\_, 2010.

ROBERT M. MCKENNA  
Attorney General

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JONATHAN C. THOMPSON  
Assistant Attorney General  
Counsel for Washington Utilities and  
Transportation Commission Staff