Exhibit No. ___-THC (BAE-1THC)
Docket UT-082119
Witness: Betty A. Erdahl
REDACTED VERSION

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Joint Application of **EMBARQ CORPORATION AND CENTURYTEL, INC.** **For Approval of Transfer of Control of United Telephone Company of the Northwest d/b/a Embarq and Embarq Communications, Inc.**	**DOCKET UT-082119**

TESTIMONY

OF

BETTY A. ERDAHL

ON BEHALF OF THE STAFF OF WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

March 4, 2009

HIGHLY CONFIDENTIAL PER PROTECTIVE ORDER
REDACTED VERSION

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I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Betty A. Erdahl, and my business address is 1300 South Evergreen Park Drive Southwest, P.O. Box 47250, Olympia, Washington 98504. My business e-mail address is berdahl@utc.wa.gov

Q. By whom are you employed and in what capacity?

A. I am employed by the Washington Utilities and Transportation Commission (commission) as a Telecommunications Regulatory Analyst.

Q. What are your education and experience qualifications?

A. I graduated from Washington State University with a Bachelor of Arts in Accounting, December 1988. Before joining the commission as an analyst in June 1991, I worked for two years as an accountant in the financial sector.

Since joining the commission, I have completed coursework in "Basics of Regulation" offered by New Mexico State University, Rate Making Process Technical Program, as well as a USTA class on Understanding Separations, Access Charges, and Settlements.

As a Regulatory Analyst, I am responsible for auditing the books and records of regulated companies, analyzing cost of service studies, examining affiliated interest transactions, and making policy recommendations to this commission. In addition, I recommend rates to the commission that allow for the appropriate revenue requirement, and prepare exhibits and testimony regarding these investigations for presentation before the commission. I also have worked on policy issues relating to payphone deregulation, local calling areas, bundling of regulated and nonregulated telecommunications services, implementation of N11 pursuant to the Telecommunications Act of 1996, and numbering resources.

Q. Have you testified before this Commission?

A. Yes. I testified before this commission first in Docket TG-920090, regarding affiliated interests of Waste Management, Inc.; in Docket UT-950200, regarding accounting adjustments in the general rate case filed by U S WEST Communications, Inc.; in Docket UT-970066, regarding payphone access line rates of Toledo Telephone Company; and in Docket UT-020406, a complaint case filed by AT&T Communications of the Pacific Northwest, Inc. against Verizon Northwest Inc.'s access charge rates. I also prepared testimony in Docket UT-040788, regarding accounting adjustments in the general rate case filed by Verizon Northwest Inc.; and Docket UT-051291 regarding affiliated interest contracts, overall earnings review, and recommended a provision of a quality of service guarantee program in the Sprint spin-off of its local exchange companies.

Q. Please identify and describe the Embarq and CenturyTel entities that are involved in the transaction that is under review and how they are named in your testimony.

A. Embarq Corporation (Embarq), headquartered in Overland Park, Kansas, offers local exchange telecommunications service in 18 states, through its numerous operating companies. Embarq had $8.7 billion in assets as of the end of September 2008 and received $4.6 billion in revenue during the first three quarters of 2008. United Telephone Company of the Northwest d/b/a Embarq (United) is a local exchange company (LEC) that provides service to about 73,000 customers (as of 2007 year end) in Jefferson, Yakima, Klickitat, Skamania, Grant, and Benton counties, as well as in parts of Oregon. United is a wholly-owned subsidiary of Embarq.

CenturyTel, Inc. (CenturyTel), headquartered in Monroe, Louisiana, is also a telecommunications carrier providing services in small-to-mid-size cities in 25 states through its many operating companies. CenturyTel had $8.3 billion in assets as of the end of September 2008 and received revenues of $2 billion during the first three quarters of 2008. CenturyTel of Washington, Inc., CenturyTel of Inter Island, Inc., and CenturyTel of Cowiche, Inc. (collectively CenturyTel LECs) are Washington local exchange companies that are all wholly-owned subsidiaries of CenturyTel. The CenturyTel LECs serve 152,000 access lines (as of 2007 year end) in Clallam, Jefferson, Grays Harbor, Pacific, Wahkiakum, Clark, Cowlitz, Lewis, Mason, Pierce, King, Kitsap, San Juan, Okanogan, Douglas, Grant, Yakima, Kittitas, Franklin, Walla Walla, Columbia, Adams, Whitman, Lincoln, Spokane, Ferry, and Stevens counties.

II. PURPOSE OF TESTIMONY

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to:

a) Address some of the risks of the transaction with regard to potential rate and quality of service impacts; and

b) Propose that the commission require the merging companies to meet certain conditions in order to ensure that there is no harm to consumers as a result of the transaction.

Staff witness William Weinman addresses other risks of the transaction and proposes additional conditions to ensure the merger does not harm ratepayers.

III. POTENTIAL HARM

Q. Did staff analyze the proposed transaction for potential harm to Washington consumers?

A. Yes. Consistent with the commission's "no harm" standard for approval of a merger or divestiture transaction, staff analyzed the proposed merger for potential harms to competition, rates, and quality of service.

Q. What did staff find with regard to potential harms to competition?

A. Because the companies do not presently compete for customers, including long distance customers, staff is not concerned that the merger will result in diminished competition.

Another competition related issue concerns interconnection and the provision of unbundled network elements under the 47 U.S.C. § 251(c). The issue is that Embarq provides its wireline competitors with access to unbundled network elements (UNEs) pursuant to the Federal Telecommunications Act of 1996. CenturyTel does not provide access to UNEs, because it asserts the rural exemption of 47 U.S.C. § 251(f). Staff understands that some competitive local exchange carriers were concerned about whether they would still enjoy the same access to UNEs from United following the merger. It is staff's belief the merging companies have committed to continue to provide UNEs through the Embarq local exchange companies, including United following the merger, based on this statement in the Direct Testimony of G. Clay Bailey:

> [United] and the CenturyTel ILECs will retain their corporate identity. They will remain subject to the same provisions of the 1996 Telecom Act and Washington statutes and regulations as they were before the Transaction. Also, all interconnection agreements they have executed will remain enforceable.

Exh. No. ____(GCB-DT) at 15:4-7. In order to ensure that there is no harm to consumers through a reduction in a choice of competitors in United's service area, the commission should require that CenturyTel commit not to assert the rural exemption of 47 U.S.C. § 251(f) with respect to United.

Q. What did staff find with regard to risk of increased rates or diminished quality of service?

A. Staff is concerned about the *potential* for harm in the form of higher rates, diminished investment in the local exchange companies, and diminished service quality for both United and the CenturyTel ILECs.

Staff believes that the merger poses the following risks to Washington local exchange service customers of the merging companies:

a) Potential rate impacts due to the cost of the merger, branding and integration of the companies, that would not have otherwise occurred had the merger not transpired;

b) Potential quality of service impacts related to management focus on the integration of the two companies; poor customer care due to consolidation of call centers resulting in longer wait times on customer calls; and

c) Decreased investment in local exchange companies due to pressure to realize synergy savings; cash could be funneled from the local exchange companies to fund affiliated ventures, nonregulated activities, payment of dividends or corporate expenses that Washington ratepayers would not otherwise pay, thereby leave the local exchange companies with less cash to invest in the network and service of the network.

The companies predict that the merger will result in company-wide savings of $400 million in annual expenses once integration of the companies is complete. However, these savings will come at a cost of $275 million and they are not assured.

CenturyTel has a long history of acquiring and integrating telecommunications exchanges and operations but it has never attempted anything on this scale. Embarq is about 2.4 times larger than CenturyTel in terms of revenues and 2.9 times larger in terms of access lines. According to CenturyTel's G. Clay Bailey, this transaction is the company's largest single acquisition to-date. The company's prior largest acquisition involved 660,000 access lines. Exh. No. ___ (GCB-DT) at 10. The proposed transaction with Embarq is of a completely different order of magnitude, involving almost nine times that number of access lines (about 5.8 million).

In addition, the companies' synergy saving projections appear very speculative and are not at all developed at the state level, let alone the individual operating company level. Highly Confidential Exh. No. __HC (BAE-2HC) and Exh. No. __ (BAE-3). Given this fact, it is not clear whether Washington customers of United and the CenturyTel ILECs will be net winners in terms of savings, or whether the Washington local exchange companies might be used as "cash cows" to pay for merger related expenses to achieve savings that may be realized elsewhere.

IV. CONDITIONS TO ADDRESS POTENTIAL HARM

Q. What conditions does staff recommend to mitigate the potential harm?

A. In addition to the conditions proposed in Mr. Weinman's testimony, staff proposes the following conditions to protect Washington ratepayers from the potential harms described above:

A. Continued application of all spin-off conditions to United,

B. Additional affiliated interest transaction reporting,

C. Quality of service guarantee offered to CenturyTel LEC customers in Washington State including reporting of payouts, and

D. Reporting on the response time for calls placed to business office or repair centers.

A. Continued Application of all Spin-off Conditions to United

Q. Is United currently subject to special conditions arising from a prior case?

A. Yes. In Docket UT-051291, Sprint Nextel petitioned the commission for approval to spin-off United Telephone Company of the Northwest d/b/a Embarq (United) as part of a plan to divest itself of local exchange carriers (LECs) throughout the country. In its Order 06 in that docket, the commission approved the transaction subject to conditions adopted under a settlement.

Q. Should all of the conditions the commission imposed in Docket UT-051291 continue to apply to United if the merger is approved?

A. Yes. To the extent that they still apply, all settlement conditions in UT-051291 should continue to apply to United whether or not the merger is approved. The conditions and reasons to continue to apply the conditions follow:

1. Directory Sale

> Of the Washington portion of the gain on sale of Sprint's directory publishing operations, $9,789,750 will be attributed to ratepayers. The $9,789,750 will be amortized over ten years resulting in an annual amortization of $1.451M. This directory gain on sale amortization will begin on January 1, 2008, or on the

effective date of any new rates that are developed as a result of a rate case or an earnings investigation, whichever is earlier. At the time the directory gain on sale amortization described in this section begins, the amortization will replace existing directory imputation. The amortization period will continue for ten years, after which time the directory gain on sale amortization will cease.

The importance of this condition is to flow the revenue from the sale of the yellow page business to Washington ratepayers.

2. Recovery of Separation, Branding & Transition Costs

United will not seek recovery from ratepayers of any separation, branding or transition costs of the separation in rates, including, but not limited to, transaction costs (accounting, banker, legal advisor and other fees), dissynergies, severance costs associated with the separation and costs of developing and establishing the new brand.

This condition assures Washington ratepayers will not pay for expenses that would not have otherwise occurred had the spin-off not transpired.

3. Service Guarantee is now offered in United's Washington tariff

United made a tariff filing to offer a service guarantee in its tariff to match the Nevada tariff provisions with one exception: the credit will be for fixed amounts rather than be tied to a local monthly service charge which could vary by exchange. Effective January 1, 2007, automatic credits will be provided to customers for each repair commitment or each installation commitment missed due to reasons within the Company's control. The credit will be a fixed $15 for residential and $25 for basic business (i.e. B1) customers.

The service guarantee provides a financial incentive to continue to provide good installation and repair service and will compensate customers when service is inadequate.

4. Service Quality – United complies with commission service quality rules

United will continue to comply with the applicable commission-approved service quality requirements; provided, however, that United shall be allowed to seek changes in or relief from such requirements consistent with provisions of the Revised Code of Washington (RCW), Washington Administrative Code (WAC), or commission orders.

5. Customer Notice

United met this requirement and it is no longer applicable.

6. Finance Conditions

These conditions are addressed in the testimony of staff witness William Weinman.

7. Affiliated Interest Agreements

a. If United is a signing party to any contracts negotiated with Sprint Nextel prior to the completion of the separation, United will acknowledge that it is an affiliated interest of Sprint Nextel, as that term is used in Chapter 80.16 RCW, for as long as any contract negotiated prior to separation is in effect.

b. If United is a signing party to a contract with Sprint Nextel, negotiated prior to the completion of the separation and which continues in effect, Sprint Nextel and/or United agrees to provide cost data in any proceeding in which United's regulated revenue or expenses relating to these contracts is at issue, so that the commission is able to calculate a) the lower of cost or market standard for affiliated interest transactions with compensation from United to Sprint Nextel and b) the higher of cost or market standard for affiliated interest transactions with compensation from Sprint Nextel to United (or at tariffed rates if available) for use in the proceeding.

The impact of this condition was to assure that United would not be saddled with unreasonable payments to its affiliates that became part of Sprint Nextel following separation. The affiliated interest transactions were agreed to prior to the spin-off and were not arm's-length transactions.

8. Broadband Deployment

United agrees to provide information to staff or Public Counsel upon request concerning how, when, and where it has deployed broadband services.

B. Additional Affiliated Interest Transaction Reporting

Q. What is staff's recommendation regarding reporting of transactions between the CenturyTel LECs, United, and their affiliates?

A. Staff recommends that the commission require additional affiliated interest reporting to make clear any changes in affiliated transactions from pre- to post-merger, and throughout the integration period. The report should explain how the affiliates are being merged or which affiliate will be used in the future (CenturyTel versus a former Embarq affiliate), along with a rate comparison of current payments versus post-merger payments. The rate comparison will include all payments made to an affiliate or payments received from an affiliate after integration of CenturyTel and the Embarq companies.

Q. What is an affiliated interest?

A. An affiliated interest is defined an entity that owns, or holds direct or indirect ownership of five percent or more of the voting securities of any public service company engaged in any intrastate business in Washington. It also covers every corporation or person with which the public service company has a management or service contract.[1] Non-competitively classified telecommunications companies are required by statute[2] and rule[3] to file with the commission copies of any contracts or arrangements they enter into with their affiliates.

The Washington Supreme Court summarized the rationale for the affiliated interest statutes, RCW 80.16, in the following manner:

> The general rationale for the Commission's authority to review transactions between affiliated companies is fear of collusion in the absence of arm's-length dealings. It does not matter under these statutes whether the utility paid the affiliate too much money for too little service or property, or whether (as here) the utility gave the affiliate something of far greater value that the affiliate paid for in return. The effect in either situation is to give to the shareholders of the affiliate something of value at the expense of the ratepayers of the utility.[4]

[1] RCW 80.16.010.
[2] RCW 80.16.020.
[3] WAC 480-120-375.
[4] *US West Communications, Inc. v. Utilities and Transp. Comm'n,* 134 Wn. 2d 74, 94, 949 P.2d 1337 (1997).

In order to address this potential for collusion, RCW 80.16.030 authorizes the commission to disallow unreasonable compensation to an affiliated company for purposes of rate making.[5]

Q. If the companies are already required by statute and rule to file their affiliated interest contracts and agreements with the commission, why does staff recommend this additional reporting as a condition of the commission's approval of the proposed merger?

A. It is unclear whether the local ratepayers of the merged company will receive a benefit due to the merger. In order to ensure that captive customers of the regulated local exchange companies will not end up paying higher rates to cover any of the costs associated with the merger, it is important for staff to be able to monitor the regulated local exchange companies' transactions with their affiliates.

Based on the Applicants' explanation of the synergy savings to be realized as a result of the merger, staff would expect United and the CenturyTel LECs to experience a decrease in payments to affiliates as the projected synergies are achieved. The companies estimated a savings of $400 million nationwide, [redacted], services that the CenturyTel and Embarq local exchange companies in Washington, and other states, purchase from their affiliated parent companies. Thus, if the projected synergies are realized, staff

[5] *Id.* at 92-93.

would expect to see the cost of these services decrease, and consequently, a decrease in expenses at the operating company level that would be recoverable in rates. A decrease in payments to affiliates would be realized in any future review of the local exchange carriers' local rates.

In summary, the additional reporting that staff recommends will provide staff with a clearer understanding of the new relationships post-merger in comparison with premerger affiliated relationships. This reporting will also allow staff to monitor payments made to and from affiliates of the LECs indicating the savings that flow through to the LECs, in the event a rate case were to be filed. As Mr. Weinman states in his testimony, local rates of the merged company must not increase because of increased payments for services that would not be incurred if it were not for the merger, because there is no added value to the ratepayers of the local telephone company.

C. Quality of Service Guarantee Offered to CenturyTel LEC Customers in Washington State Including Reporting of Payouts

Q. When considering whether this application is in the public interest, did staff consider quality of service?

A. Yes. Staff reviewed the monthly service quality reports of United and the CenturyTel LECs for the calendar year 2007. Telecommunications companies are subject to the service quality reporting requirements in WAC 480-120-439; performance standards for installation or activation of service contained in WAC

480-120-105; response time standards contained in WAC 480-120-133; trouble report standards contained in WAC 480-120-438; network performance standards contained in WAC 480-120-401; and repair standards contained in WAC 480-120-440.

Generally, United and the CenturyTel LECs meet the service quality benchmarks established by the commission, so staff is not concerned about the companies' current service quality.

Instead, as discussed above, staff is concerned that there is a risk of decline in quality of service due to management's focus on the integration of the two companies resulting in less time spent on providing good and timely service and repairs to customers.

Another concern is that much of the savings attributed to the merger is to come from efficiencies in areas that have a direct connection to service quality. The companies project a saving of: [redacted].

Q. What is staff's recommendation regarding a quality of service guarantee?

A. Staff recommends that the merged company be required to offer the same quality of service guarantee currently offered by United to all Washington customers, including customers of the CenturyTel LECs. A copy of the United's service guarantee is included in Exh.___(BAE-4). Staff also recommends that the merged company be required to report quarterly all amounts paid under the quality of service guarantee to customers in Washington State throughout the integration period. A quality of service guarantee provides the customer compensation for their time if an appointment is missed and creates a financial disincentive for the company to miss such an appointment or commitment.

Q. Why does staff recommend quarterly reporting on the merged company's quality of service guarantee program?

A. The report will allow staff to see how the merged company is performing with regard to providing good and timely service and repairs to customers throughout the integration period. If the reports indicate an increase in payouts to customers under the quality of service guarantee program, at that point staff may examine the situation further to determine what the cause is and if it appears to be a sign of degradation of service.

D. Reporting on the Response Time for Calls Placed to Business Office or Repair Centers

Q. Does staff recommend any other conditions related to quality of service?

A. Yes. Staff recommends that the merged company be required to report quarterly information on the response time for calls placed to its business office or repair centers throughout the integration period.

Q. What is the importance of receiving reports regarding the response time for calls placed to the business office or repair centers on a quarterly basis throughout the integration?

A. Under WAC 480-120-439(10), local exchange companies must file business office and repair answering system reports when requested. Although not a monthly reporting requirement, companies are required to submit these reports, when requested by the commission, to determine whether a company is experiencing significant problems in this area. Staff currently tracks the number of answer time complaints to see if a company is experiencing problems. Because the merging companies' savings and synergies predictions depend on [redacted], including the potential for the closure of business or repair centers, staff recommends the merged company submit this report during the integration period so that staff is able to monitor the effects of the transaction on customers.

Q. Why is it reasonable to impose the staff recommended service quality conditions to the newly merged company?

A. The conditions allow staff to monitor the merged company's performance and address any concerns regarding service quality to mitigate potentially negative consequences of the merger and the integration of the local exchange carriers' operations and networks.

Q. Does this conclude your testimony?

A. Yes.