BEFORE THE WASHINGTON UTILITIES & 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 NO. UT-090842

DIRECT TESTIMONY OF STEPHEN G. HILL (SGH-1HCT)

ON BEHALF OF

PUBLIC COUNSEL

NOVEMBER 3, 2009

REDACTED VERSION

HIGHLY CONFIDENTIAL VERSION

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DIRECT TESTIMONY OF STEPHEN G. HILL (SGH-1HCT)
DOCKET NO. UT-090842

TABLE OF CONTENTS

PAGE

I. INTRODUCTION / SUMMARY………………………………………………………… 1
II. MERGER OVERVIEW…………………………………………………………………. 12
III. FINANCIAL ISSUES……………………………………………………………………….20
  A. Overview Of Public Data……………………………………………………………20
  B. Confidential Financial Projections……………………………………………..33
IV. CONDITIONAL RECOMMENDATIONS…………………………………………....49

FIGURES

Figure 1. Frontier, S&P 500, NASDAQ Telecom Index Relative Stock Prices 4/1/09-9/14/09…………...15
Figure 2. Highly Confidential Spinco Financials………………………………………….35
Figure 3 Highly Confidential Spinco Operating Expenses……………............................36
Figure 4 Highly Confidential Frontier Capital Expenditures…………………………......39
Figure 5 Highly Confidential Spinco Capital Expenditures………………………………41
Figure 6 Highly Confidential Combined Company Capital Expenditures………………..42

STEPHEN G. HILL'S EXHIBIT LIST

Exhibit No. ___ (SGH-2) Education and Employment History
Exhibit No. ___ (SGH-3) Frontier Verizon Merger Application: Risk Factors
Exhibit No. ___ (SGH-4) WSJ article, "Two Sides of Verizon's Deal Making"
Exhibit No. ___ (SGH-5) Frontier-Verizon Merger Application Spreadsheet Historical Data
Exhibit No. ___ (SGH-6) Verizon Merger Application Spreadsheet Historical Data
Exhibit No. ___ (SGH-7) Frontier-Verizon Merger Application Spreadsheet Spinco Historical Data
Exhibit No. ___ (SGH-8) Verizon-Wireless Customer Letter dated May 26, 2009

1 ## I. INTRODUCTION / SUMMARY

2 **Q: Please state your name, occupation and business address.**

3 A: My name is Stephen G. Hill. I am self-employed as a financial consultant, and
4 principal of Hill Associates, a consulting firm specializing in financial and
5 economic issues in regulated industries. My business address is P.O. Box 587,
6 Hurricane, West Virginia, 25526 (e-mail: hillassociates@gmail.com).

7 **Q: Briefly, what is your educational background?**

8 A: After graduating with a Bachelor of Science degree in Chemical Engineering
9 from Auburn University in Auburn, Alabama, I was awarded a scholarship to
10 attend Tulane Graduate School of Business Administration at Tulane University
11 in New Orleans, Louisiana. There I received a Master's Degree in Business
12 Administration. More recently, I have been awarded the professional designation,
13 "Certified Rate of Return Analyst" by the Society of Utility and Regulatory
14 Financial Analysts. This designation is based upon education, experience and the
15 successful completion of a comprehensive examination. I have also been elected
16 to the Board of Directors of that national organization. A detailed account of my
17 educational background and occupational experience appears in Exhibit
18 No.___(SGH-2), attached to this testimony.

19 **Q: Have you testified before this or other regulatory Commissions?**

20 A: Yes, I have appeared previously before this Commission. In addition, I have
21 testified on cost of capital, corporate finance and capital market issues in more
22 than 250 regulatory proceedings before the following regulatory bodies: the West
23 Virginia Public Service Commission; the Texas Public Utilities Commission; the

1 Arizona Corporation Commission; the Oklahoma State Corporation Commission;
2 the Public Utilities Commission of the State of California; the Pennsylvania
3 Public Utilities Commission; the Maryland Public Service Commission; the
4 Public Utilities Commission of the State of Minnesota; the Ohio Public Utilities
5 Commission, the Insurance Commissioner of the State of Texas; the North
6 Carolina Insurance Commissioner; the Massachusetts Department of Public
7 Utilities; the Rhode Island Public Utilities Commission; the City Council of
8 Austin, Texas; the Texas Railroad Commission; the Missouri Public Service
9 Commission; the South Carolina Public Service Commission; the Public Utilities
10 Commission of the State of Hawaii; the New Mexico Corporation Commission;
11 the State of Maine Public Utilities Commission; the Georgia Public Service
12 Commission; the Public Service Commission of Utah; the Illinois Commerce
13 Commission; the Kansas Corporation Commission; the Indiana Utility Regulatory
14 Commission; the Virginia Corporation Commission; the Montana Public Service
15 Commission; the Public Service Commission of Wisconsin; the Vermont Public
16 Service Board; the Federal Communications Commission; and the Federal Energy
17 Regulatory Commission. I have also testified before the West Virginia Air
18 Pollution Control Commission regarding appropriate pollution control technology
19 and its financial impact on the company under review and have been an advisor to
20 the Arizona Corporation Commission on matters of utility finance.
21 **Q: On behalf of whom are you testifying in this proceeding?**
22 A: I am testifying on behalf of the Public Counsel Section of the Washington State
23 Attorney General's Office (Public Counsel).

1 **Q: What is the purpose of your testimony?**

2 A: In this proceeding, I have been retained by the Public Counsel to review, analyze,
3 and comment on the financial aspects of the proposed $8.6 billion transaction in
4 which Frontier Communications Corporation (Frontier) intends to acquire the
5 local exchange operations in Washington and 13 other states from Verizon
6 Communications, Inc. (Verizon).

7 **Q: Have you prepared exhibits in support of your testimony?**

8 A: Yes, my narrative testimony is presented as Exhibit No.___(SGH-1T).
9 Exhibit No.___(SGH-2) contains my vitae, and Exhibit No.___(SGH-3) through
10 Exhibit No.___(SGH-8) provide additional quantitative support for the
11 conclusions reached regarding the proposed transaction. These exhibits were
12 prepared by me and are correct to the best of my knowledge and belief.

13 **Q: Please summarize your testimony and findings concerning the proposed**
14 **acquisition of Verizon's telephone assets by Frontier.**

15 A: My testimony is presented in three sections.

16 - First, I summarize the financial aspects of the proposed transaction as well
17 as the transaction rationale presented by the Companies.
18 - In the second section of my testimony, I discuss issues related to the
19 financial details of the proposed transaction that have not been discussed by
20 the Applicants in their filed testimony in this proceeding. Those issues, when
21 considered, indicate that the transaction as currently proposed increases
22 financial risks, is grounded on optimistic forecasts that are based on untested
23 revenue and expense allocations, does not appear to provide for sufficient

1 capital expenditures to support expanding services and, therefore, is not in the
2 public interest. My conclusion is that the merger, as proposed, should be
3 denied.

4 • Third, if the Commission decides to approve the transfer of Verizon's
5 telephone properties in Washington to Frontier, I recommend measures that
6 will help support the future financial viability of the successor corporation in
7 order to assure that the transaction is in the public interest, *i.e.* that it will not
8 harm Washington ratepayers.

9 My review of the evidence in this proceeding indicates that Frontier's post-merger
10 financial projections do not take into account the potential for substantial
11 downside events. Although Frontier discusses the significant risks associated
12 with this transaction in detail in its S.E.C. Form S-4, it does not appear to have
13 accounted for those risks in the financial projections on which the proposed
14 transaction is based. Also, a central element of the transaction—the valuation of
15 Verizon's telephone assets (Spinco)—is determined through an allocation process
16 in a "carve-out" of the Spinco operations from Verizon's general telephone
17 operations. That allocation of costs, capital, and revenues to a business that never
18 existed on a stand-alone basis was determined by Verizon management—the
19 seller—and serves as a primary basis for the $8.6 billion valuation. Moreover, the
20 financial advisors for each company (Evercore and Citigroup for Frontier and JP
21 Morgan and Barclay's for Verizon) make very clear that their determination of the
22 "fairness" of the transaction relied on the accuracy of the financial projections for
23 the merged company provided by management and that those financial advisors

1 undertook no independent verification of those projections. As I noted above, the
2 operating assumptions underlying those post-merger financial projections appear
3 to employ only the very best outcomes.

4 While I will recommend steps that I believe can assist the Commission in
5 helping support the financial well-being of a post-merger Frontier/Spinco if this
6 Commission elects to approve the transaction, it is my view that a more efficient
7 way to enable the merged entity to avoid financial difficulty would be to lower the
8 sale price Verizon requests for Spinco, or otherwise condition the approval on
9 some additional significant monetary contribution by Verizon.

10 However, my reading of the merger agreement indicates that these more
11 efficient approaches cannot happen. According to the merger agreement, any
12 difference from the currently agreed-upon sale price of Spinco or additional
13 contribution required by regulators will be recovered from Frontier by Verizon's
14 stockholders. In other words, if regulators require any sort of monetary
15 contribution by Verizon, according to the merger agreement, Frontier will have to
16 pay Verizon the originally-agreed upon value for the Spinco assets *plus* the value
17 of any regulatory "claw back." Thus, any regulatory adjustment that requires
18 compensation or give-back by Verizon will ultimately be the responsibility of,
19 and paid by, Frontier—on top of the purchase price:

20 1.167 "Spinco Closing Equity Value" means the amount
21 equal to the sum of (A) $5.247 billion plus (B) the
22 Required Payment Amount, if any.
23
24 1.144 "Required Payment Amount" means the aggregate
25 amount, if any, of all amounts required to be paid,
26 refunded, deferred, escrowed, or forgone pursuant to an
27 order, settlement agreement or otherwise…by Verizon or

> its Subsidiaries, other than post-Closing obligations of Spinco or any Spinco Subsidiary, as a condition to obtaining any consent of any governmental Authority in the Territory required to consummate the Distribution or the Merger or to complying with any order approving the Distribution and the Merger.[1]

Therefore, in order to set a lower sale price or require a monetary contribution from Verizon, the current merger agreement cannot be approved as written. A lower sale price or a substantial monetary contribution by Verizon, and thereby a more certain financial future for a merged Frontier/Spinco, can only come about if the current merger is rejected or the Commission conditions approval of the merger on changing the written conditions in the merger agreement cited above.

Therefore, my primary conclusion in this proceeding is that the merger agreement, as written, is not in the public interest and should be rejected. If the Commission elects to approve the merger, then the approval should be conditioned to require the Applicants to alter that portion of the merger agreement requiring Frontier to shoulder responsibility for any monetary contribution required by Verizon.

Q: Can you summarize your concerns related to the proposed merger?

A: Many of the concerns I have in reviewing this proposed transaction are also discussed in Frontier's most recent S.E.C. Form S-4 (September 9, 2009).[2] This is a pubic document, and I have attached a complete copy of the "Risk Factors"

[1] Exhibit 1, Agreement and Plan of Merger Dated as of May 13, 2009 By and Among Verizon Communications Inc., New Communications Holdings Inc. and Frontier Communications Corporation, pp. 21 and 22.

[2] An earlier version of the S-4 was provided by Frontier witness McCarthy in a supplemental exhibit, Exhibit No.___(DM-7).

1 section of that S-4 as Exhibit No.___(SGH-3). Although I will discuss some of
2 the issues listed below in more detail subsequently, as well as other issues not
3 mentioned in the list below, I will let the Company's own words summarize many
4 of the problems inherent in the proposed merger:

- **Frontier's effort to combine Frontier's business and the Spinco business may not be successful.** The acquisition of the Spinco business is the largest and most significant acquisition Frontier has undertaken…. [T]he size and complexity of the Spinco business and the process of using Frontier's existing common support functions and systems to manage the Spinco business after the merger, if not managed successfully by Frontier management, may result in interruptions of the business activities of the combined company that could have a material adverse effect on the combined company's business, financial condition and results of operations…. The size, complexity and timing of this migration, if not managed successfully by Frontier management, may result in interruptions of Frontier's business activities….

- **The combined company may not realize the growth opportunities and cost synergies that are anticipated from the merger.** The success of the merger will depend, in part, on the ability of the combined company to realize anticipated growth opportunities and cost synergies…. Even if the combined company is able to integrate the Frontier and Spinco businesses and operations successfully, this integration may not result in the realization of the full benefits of the growth opportunities and cost synergies that Frontier currently expects from this integration within the anticipated time frame or at all.

- **After the close of the transaction, sales of Frontier common stock may negatively affect its market price.** The market price of Frontier common stock could decline as a result of sales of a large number of shares of Frontier common stock in the market after the completion of the merger or the perception that these sales could occur. To the extent permitted under the tax sharing agreement, any effort by the combined company to obtain additional capital by selling equity securities in the future will be made more difficult by such sales, or the possibility that such sales may occur.

- **If the assets contributed to Spinco by Verizon are insufficient to operate the Spinco business, it could adversely affect the combined company's business, financial condition and results of operation.**... [T]he contributed assets may not be sufficient to operate all aspects of the Spinco business and the combined company may have to use assets or resources from Frontier's existing business or acquire additional assets in order to operate the Spinco business, which could adversely affect the combined company's business, financial condition and results of operations.

- **The combined company's business, financial condition and results of operations may be adversely affected following the merger if it is not able to obtain consents to assign certain Verizon contracts to Spinco.** Certain wholesale, large business, Internet service provider and other customer contracts that are required to be assigned to Spinco by Verizon require the consent of the customer party to the contract to effect this assignment. Verizon and the combined company may be unable to obtain these consents on terms favorable to the combined company or at all, which could have a material adverse impact on the combined company's business, financial condition and results of operations following the merger.

- **Frontier will be unable to take certain actions after the merger because such actions could jeopardize the tax-free status of the spin-off or the merger, and such restrictions could be significant.** Because of these restrictions, for two years after the merger, Frontier may be limited in the amount of capital stock that it can issue to make acquisitions or to raise additional capital.

- **The pendency of the merger could adversely affect the business and operations of Frontier and the Spinco business.** In connection with the pending merger, some customers of each of Frontier and the Spinco business may delay or defer decisions or may end their relationships with the relevant company, which could negatively affect the revenues, earnings and cash flows of Frontier and the Spinco business, regardless of whether the merger is completed.

- **The combined company will likely face further reductions in access lines, switched access minutes of use, long distance revenues and federal and state subsidy**

revenues, which could adversely affect it. These factors, among others, are likely to cause the combined company's local network service, switched network access, long distance and subsidy revenues to continue to decline, and these factors may cause the combined company's cash generated by operations to decrease.

- **The combined company will face intense competition, which could adversely affect it.**

- **Some of the combined company's future competitors will have superior resources, which may place the combined company at a cost and price disadvantage.**

- **The combined company may be unable to grow its revenues and cash flows despite the initiatives Frontier has implemented and intends to continue after the merger.**

- **The combined company's business will be sensitive to the creditworthiness of its wholesale customers.** The combined company will have substantial business relationships with other telecommunications carriers for whom it will provide service. While bankruptcies of these carriers have not had a material adverse effect on Frontier or the Spinco business in recent years, future bankruptcies in their industry could result in the loss of significant customers by the combined company, as well as more price competition and uncollectible accounts receivable. Such bankruptcies may be more likely in the future if current economic conditions continue into 2010 or beyond. As a result, the combined company's revenues and results of operations could be materially and adversely affected.

- **Substantial debt and debt service obligations may adversely affect the combined company.** Frontier has a significant amount of indebtedness, which amounted to approximately $4.9 billion as of June 30, 2009. The Spinco business will have indebtedness in the amount of approximately $3.4 billion at the closing of the merger. After the merger, the combined company may also obtain additional long-term debt and working capital lines of credit to meet future financing needs, subject to certain restrictions under the terms of Frontier's existing indebtedness, which would increase its total debt.

- **The combined company will require substantial capital to upgrade and enhance its operations.** Verizon's historical capital expenditures in connection with the Spinco business have been significantly lower than Frontier's level of capital expenditures. Replacing or upgrading the combined company's infrastructure will require significant capital expenditures, including any expected or unexpected expenditures necessary to make replacements or upgrades to the existing infrastructure of the Spinco business. If this capital is not available when needed, the combined company's business will be adversely affected. Responding to increases in competition, offering new services, and improving the capabilities of, or reducing the maintenance costs associated with, the combined company's plant may cause the combined company's capital expenditures to increase in the future. In addition, the combined company's anticipated annual dividend of $0.75 per share will utilize a significant portion of the combined company's cash generated by operations and therefore could limit the combined company's ability to increase capital expenditures significantly.

- **Changes in federal or state regulations may reduce the access charge revenues the combined company will receive.**... The FCC is considering proposals that may significantly change interstate, intrastate and local intercarrier compensation. When and how these proposed changes will be addressed are unknown and, accordingly, Frontier cannot predict the impact of future changes on the combined company's results of operations. However, future reductions in the combined company's access revenues will directly affect the combined company's profitability and cash flows as those regulatory revenues do not have substantial associated variable expenses.

- **The combined company will be reliant on support funds provided under federal and state laws.**... A portion of Frontier's revenues (approximately $120 million in the aggregate, or 5.4%, in 2008) and a portion of Verizon's Separate Telephone Operations' revenues (approximately $235 million in the aggregate, or 5.4%, in 2008) are derived from federal and state subsidies for rural and high cost support, commonly referred to as universal service fund subsidies, including the Federal High Cost Loop Fund, federal interstate access support, federal interstate common line support, federal local switching support fund, various state funds and surcharges billed to customers. The FCC and state regulatory

1 agencies are currently considering a number of proposals for
2 changing the manner in which eligibility for federal and state
3 subsidies is determined as well as the amounts of such
4 subsidies.[3]
5
6 The list of risk factors and problems the merger could encounter listed
7 above, are largely absent from the focus of the Companies' testimony in this
8 proceeding. Their presentations are, understandably, very positive and "can-do"
9 in nature. Moreover, while the above list of risks presented to Frontier's
10 stockholders is mandated by the Securities and Exchange Commission, it should
11 not be dismissed as "boilerplate" having little relevance to the success of the
12 transaction. Although the Companies would downplay the likelihood of the
13 realization of those enumerated risks, they are not fabricating them to comply
14 with SEC requirements. Those risks are real, they can cause real financial harm to
15 the surviving company, and they point out areas of concern to be explained and
16 investigated—aspects that are lacking in the Companies' testimony in this
17 proceeding.
18 While I have been retained to focus on the financial aspects of this merger
19 and will not address all the risk factors listed above, it is important for the
20 Commission to understand that there are aspects to this merger that could put the
21 financial health of a merged Frontier/Spinco in jeopardy—aspects that are not
22 discussed in the testimony provided by Frontier or Verizon representatives in this
23 proceeding.
24

[3] Frontier Communications Corp., S.E.C. Form S-4, September 8, 2009, pp. 24-36, boldface in original.

1 **II. MERGER OVERVIEW**

2 **Q: Please describe the proposed merger.**

3 A: On May 13, 2009, Frontier entered into an Agreement and Plan of Merger
4 (Merger Agreement) with New Communications Holdings (Spinco) and Verizon.
5 In the proposed transaction, Verizon will transfer its local exchange networks in
6 Arizona, Idaho, Illinois, Indiana, Michigan, Nevada, North Carolina, Ohio,
7 Oregon, South Carolina, Washington, West Virginia, and Wisconsin, and a
8 portion of Verizon's local exchange networks in California, to Frontier. In
9 addition to acquiring Verizon's local exchange business in these areas, Frontier
10 will also acquire the customer relationships for long distance, high-speed internet
11 (HIS), as well as wireline video and broadband data (*i.e.*, FiOS) services provided
12 in some areas.

13 In the initial step of the merger, Verizon's local exchange assets identified
14 above will be spun off into a separate corporate entity. Verizon will contribute
15 those assets to Spinco and, in exchange, Spinco will deliver to Verizon a cash
16 payment of approximately $3.3 billion. That cash payment will be funded by
17 term debt issued by Spinco. Following the receipt of the $3.3 billion cash
18 payment, Spinco will then merge with and into Frontier, and the shares of Spinco
19 will be converted into the number of shares of Frontier stock that Verizon
20 stockholders will be entitled to receive in the merger. Following the merger,
21 Spinco will cease to exist as a separate entity and Frontier will survive as the
22 combined company.

1 The value of the Frontier stock to be received by Verizon in the transfer of
2 telecom operations has been determined by the Applicants to be $5.247 billion.
3 Subject to an agreed-upon share price "collar" for Frontier stock, ranging from
4 $7.00 to $8.50, Frontier will issue enough shares to provide the $5.247 billion
5 asking price. If, for example, at the time of the merger Frontier's stock price were
6 $7.00, it would have to issue approximately 750 million additional shares to fulfill
7 the merger contract ($5.247 billion / $7 per share = 749.8 million shares). In that
8 event (a $7 per share stock price for Frontier at the time of the merger), Verizon
9 shareholders will own 71 percent of the combined company and Frontier
10 shareholders will own 29 percent of it. Because of the stock price "collar,"
11 Frontier is not required to issue any more than a maximum of approximately 750
12 million shares to be distributed to Verizon shareholders. However, if Frontier's
13 stock price declined below the $7 per share low-end of the"collar" prior to the
14 merger, Frontier would have to issue enough shares to provide the equity portion
15 of the sale price required by Verizon in order to complete the merger ($5.247
16 billion / $6 share price = 875 million shares), but Verizon shareholders would
17 receive a maximum of 750 million of those shares.
18 Verizon has the right to terminate the merger agreement if, during any 60
19 trading day period prior to closing, Frontier's stock price drops more than 50
20 percent below the $7.75 stock price that existed at the time the merger deal was
21 struck.[4]
22

[4] Frontier September 2009 S.E.C. Form S-4, p. 49.

1 **Q: How has the stock price of Frontier changed since the merger agreement was**
2 **signed?**
3 A: Frontier stock has not performed well. As I noted above, the stock price "collar"
4 for Frontier, $7.75, was set during negotiations as an average market price during
5 the thirty days prior to the signing of the agreement. As shown in Figure 1 below,
6 beginning about one month prior to the merger signing, at which time Frontier's
7 stock price was $7.14, the price trended slightly downward and is currently below
8 that level. This price movement is in contrast to that of either the S&P 500 Index
9 or the NASDAQ Telecom Index, both of which have shown stock price gains of
10 more than 20 percent since April 1, 2009. Relative to other stocks, then,
11 Frontier's stock price has not performed well following the merger
12 announcement. This is an indication that investors are wary about the merger
13 and, relative to other investments, have assigned Frontier a lower valuation as a
14 result of the merger announcement.
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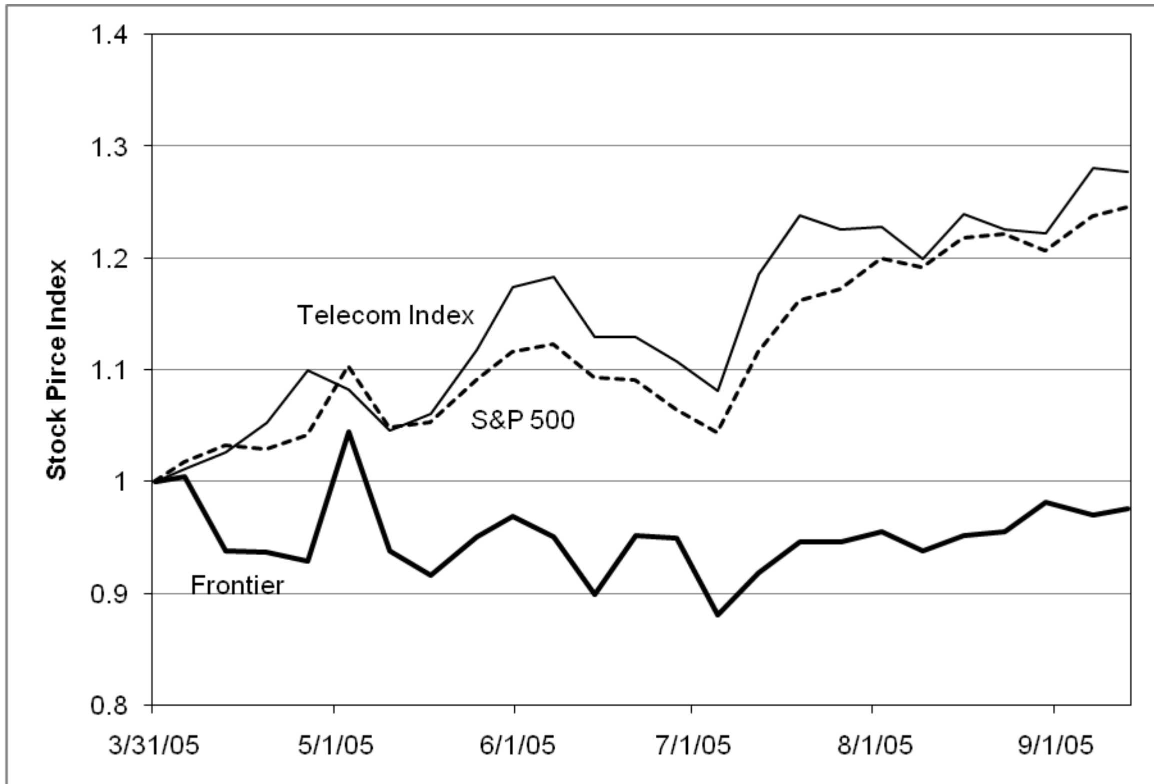
1 **Figure 1.**

2 Frontier, S&P 500, NASDAQ Telecom Index
3 Relative Stock Prices 4/1/09-9/14/09
4



5
6
7 **Q: Can you briefly summarize the rationale for the merger, as expressed by**
8 **Frontier and Verizon?**
9 A: In a very "broad brush" view, Verizon wants to sell its rural exchange telecom
10 properties because it would rather focus on its higher-margin businesses such as
11 wireless, fiber-optic network bundled communications (Internet, telephone, and
12 TV) service (FiOS), and other broadband development in areas where the
13 population is more dense and, with the $3.3 billion cash payment included in the

1 proposed transaction, enhance its financial flexibility.[5] Frontier, for its part,
2 believes there are economic opportunities for it in the rural telecom properties
3 Verizon is willing to sell. Frontier points out that its locally-focused operations
4 organization has been successful in the past and that those successes are expected
5 to be repeated in the to-be-acquired Verizon properties. Frontier expects to slow
6 down Verizon's rate of access line loss by increasing the number of high-speed
7 internet (HSI) customers through infrastructure investment, and to increase the
8 revenue realized per line by offering add-on services that Verizon does not now
9 offer. With higher per customer revenues and lower operating costs, Frontier
10 expects to be able to maintain a financially viable enterprise.[6] Also, Frontier had
11 2.2 million access lines at mid-year 2009, while the combined company would
12 have had 6.7 million at that time. By tripling the size of the company, Frontier
13 expects that economies of scale will be increased.

14 On the surface then, the Companies' "story" is appealing: Verizon's
15 primary focus is on other types of telecom properties; Frontier's operations are
16 based on relatively rural telephone operations, it has grown through acquisitions
17 and believes it can operate those properties more profitably that Verizon and with
18 better outcomes for customers. However, the core question of whether or not this
19 complex combination of companies can be successfully accomplished cannot be
20 answered only with admirable intentions, and the available evidence indicates
21 there are significant impediments to that end.

[5] Joint Applicants' Response to Public Counsel Data Request No. 90.
[6] Joint Applicants' Response to Public Counsel Data Request No. 91.

1 **Q: This proposed merger comes on the heels of other recent spin-offs by Verizon**
2 **that have not been successful, but the Applicants claim that this deal is**
3 **structured differently and will not create such serious difficulties? Is this so?**
4 A: The proposed transaction between Verizon and Frontier is structured differently
5 than Verizon's divestiture of Hawaiian Telcom, Idearc (yellow page operations),
6 and the spin-off of five million access lines in New England to FairPoint
7 Communications. While the first two transactions were heavily leveraged (used
8 mostly debt to finance the sale), this transaction is financed primarily through the
9 issuance of a very large amount of shares of Frontier's equity capital. However,
10 while not primarily financed through debt, still involves a substantial amount of
11 debt, as I will discuss further in my testimony.
12 Therefore, while the Applicants assert that this deal is structured
13 differently, that is not to say that there is no logical connection between what
14 happened in Hawaii and New England and the current transaction.
15 **Q: What similarities exist between these transactions?**
16 A: In the main, the transactions are the same—the transfer or spin-off of local
17 exchange telephone operations by Verizon to a much smaller corporate entity.
18 Frontier is not financing this deal primarily with debt, but it is increasing its debt
19 by $3.3 billion, which, at a projected interest rate of 9.5 percent, would add about
20 $300 million a year to fixed costs (9.5 percent x $3.3 billion = $313 million).
21 Also, the majority of the deal is being financed with Frontier equity, but that has
22 its costs as well. Frontier had about 310 million shares outstanding at mid-year

1 2009.[7] With a stock price at $7 per share at the time of the merger, Frontier will
2 have to issue an additional 750 million shares of stock. Even at a reduced
3 dividend of $0.75 this will add $560 million to its annual costs (750 million
4 shares x $0.75 per share = $562.5 million).

5 Also, like FairPoint and Idearc, Verizon shareholders will be the recipients
6 of the new stock issued by the acquiring entity (in this case, Frontier). Because
7 Verizon shareholders have seen the value of FairPoint and Idearc reduced to near
8 zero subsequent to the spin-off of those companies, it is conceivable that,
9 following this merger, a significant number of Verizon shareholders will sell
10 their new Frontier shares. If so, Frontier shares could flood the market exerting
11 significant downward pressure on the stock price of the new company. A
12 substantially lower stock price would make it more difficult to raise common
13 equity capital if needed. The potential market impact of Verizon's recent deal
14 making was recently discussed in the *Wall Street Journal*:

> 15 There are nonetheless consequences for a deal-
> 16 making machine like Verizon—with at least 18 transactions
> 17 in the past seven years—to leave a string of busted
> 18 companies in its wake.
> 19 These things matter greatly to how state and federal
> 20 regulators perceive the company. Maine, New Hampshire,
> 21 Vermont and Hawaii each are in an uproar over the
> 22 FairPoint divestiture, with much of the ire directed at
> 23 Verizon. "It was a great deal for Verizon," said New
> 24 Hampshire's public consumer advocate, Meredith Hatfield.
> 25 "Whether it was a great deal for New Hampshire
> 26 consumers is a different question."
> 27 It matters to market perceptions, too. "Could you be
> 28 the next FairPoint?" barked CNBC's Jim Cramer in an
> 29 interview with the chief executive of Frontier

[7] Frontier S.E.C. Form 10-Q, August 4, 2009, p. 12.

1 Communications Inc., which bought five million rural
2 landlines from Verizon in May.[8]

3 Finally on this point, while the "cut over" process of moving all of
4 Verizon's operations, billing and other back office systems is set out differently in
5 this transaction than in the FairPoint and Hawaii deals, that in no way means that
6 this is not an enormously complicated task. Public Counsel witness Trevor
7 Roycroft discusses problems inherent in transferring operations in more detail, but
8 as Frontier warns its own stockholders:

9 …the size and complexity of the Spinco business and the
10 process of using Frontier's existing common support
11 functions and systems to manage the Spinco business after
12 the merger, if not managed successfully by Frontier
13 management, may result in interruptions of the business
14 activities of the combined company that could have a
15 material adverse effect on the combined company's
16 business, financial condition and results of operations.[9]

17 In summary, while the Companies assert that this transaction is structured
18 differently than those of Hawaiian Telcom, FairPoint, and Idearc, there are
19 similarities, and those similarities indicate that the negative financial outcomes of
20 those prior deals should not be dismissed as unlikely in this instance. Also, the
21 lingering impact of the prior deals could negatively affect the financial position of

[8] Dennis K. Berman, "The Two Sides of Verizon's Deal Making," *Wall Street Journal*, Aug. 11, 2009; attached as Exhibit No. ___(SGH-3).
[9] Frontier September 2009 S.E.C. Form S-4, p. 24.

1 the combined company if the substantial increase in shares outstanding or a stock
2 sell-off drives down the price of Frontier stock. In sum, Verizon's prior deals do
3 have impact on, and are relevant to, the proposed transaction between Verizon
4 and Frontier.

5 **III. FINANCIAL ISSUES**

6 **A. Overview Of Public Data**

7 **Q: Prior to discussing the details of certain financial issues related to the**
8 **proposed transaction, can you provide a brief financial overview of the two**
9 **companies involved?**

10 A: Yes. Exhibit No.___(SGH-5) shows selected financial and operating data over
11 the past five years, as presented by Frontier in its September 8, 2009 S.E.C., Form
12 S-4. The data shown for 2009 is mid-year 2009 data reported by Frontier,
13 annualized. It is important to note that the time frame shown (2004-2009)
14 includes the acquisition by Frontier of Commonwealth Telephone in 2007.

15 Those data show that Frontier has consistently paid dividends that were
16 substantially higher than its earnings; that is, the Company has routinely been
17 paying out all of its earnings as dividends plus additional amounts from operating
18 cash flow. Frontier's earnings per share have declined from $0.78 per share in
19 2006 to $0.40 per share on an annualized basis in 2009. During that time its
20 dividends have remained at $1.00 per share. As a result of continually paying out
21 dividends in excess of earnings, the common equity in Frontier's capital structure
22 has dwindled from 24 percent of total capital in 2004 to approximately 8 percent
23 of total capital at mid-year 2009. Over the past two years (2007-2008), Frontier's

1 Revenues, Operating Income, and Income From Continuing Operations have
2 declined at 3.3 percent, 11.5 percent and 22 percent rates, respectively.[10]

3 Also, these data show that Frontier's capital expenditures (CapEx)
4 declined following its acquisition of Commonwealth Telephone in 2007, in
5 absolute terms as well as a percentage of revenues (Frontier's CapEx equals 14
6 percent of revenues in 2007 and 10 percent of revenues thus far in 2009). Finally,
7 the operating data displayed in Exhibit No.___(SGH-5) also shows that, prior to
8 the acquisition of Commonwealth Telephone, Frontier's access lines declined at
9 about 4.5 percent per year. Since 2007, even with increases in the number high-
10 speed internet customers, the rate of Frontier's access line loss has increased to
11 5.07 percent per year.[11]

12 Frontier's bond rating is below investment grade. Its current bond rating
13 from Standard & Poor's, Moody's, and Fitch is "BB," "Ba2," and "BB."[12]
14 Following the announcement of the acquisition of the Verizon properties,
15 Moody's and Fitch placed Frontier's bond ratings on a "positive" watch
16 indicating that the addition of those properties may improve the financial risk of
17 the company; however, S&P made no change in its bond rating status for Frontier
18 as a result of the announcement.[13] Importantly, none of the bond rating agencies
19 indicated that the addition of the Verizon properties to Frontier or the issuance of

[10] Operating Income equals Revenues less Operating Expenses; Income From Continuing Operations equals Operating Income less Interest Expense and Income Taxes and does not include one-time additions or charges related to temporary events.
[11] This latter fact argues against the Company's claim that increasing the number of HSI subscribers will slow the rate of access line loss.
[12] Joint Applicants' Response to Public Counsel Data Request No. 186.
[13] Joint Applicants' Response to Public Counsel Data Request No. 186. Joint Applicants' Response to Public Counsel Data Request No. 204, Attachment FRO204, Rating Agency Reports.

1 a substantial amount of equity capital would result in an investment-grade
2 company.[14]
3 The recent financial history of Verizon Communications, Inc., is shown in
4 Exhibit No.___(SGH-6). Those data show increasing revenues and net income
5 from continuing operations, as well as relatively steady earnings and dividends
6 per share, with an average dividend payout at approximately 80 percent of
7 earnings. While Verizon's wireline revenues have been declining, its wireless
8 operations and other service offerings have more than made up for that decline.
9 Exhibit No.___(SGH-6) also shows that Verizon has been capitalized on average
10 with about 53 percent common equity and 47 percent debt and, at year-end 2008,
11 the common equity ratio was 45 percent of total contributed capital. Verizon's
12 current bond rating is investment grade: "A" (S&P), "A3" (Moody's), and "A"
13 (Fitch).[15]
14 The simple conclusion based on a review of the financial status of Frontier
15 and Verizon Communications (the current owner of the Spinco properties) is that
16 Frontier is a much smaller and considerably more financially risky company than
17 Verizon. Currently, as part of Verizon, the cost of capital of the telecom
18 properties to be spun off (Spinco) is lower that it would be if those operations
19 become part of Frontier. Therefore, if the proposed transaction proceeds, the cost
20 of capital of the Spinco properties will be higher than it is now.
21

[14] Joint Applicants' Response to Public Counsel Data Request No. 204.
[15] Verizon Communications 2008 S.E.C. Form 10-K, Ex. 13.

1 **Q: How does Frontier compare on a financial/operating basis with the Spinco**
2 **properties?**
3 A: Exhibit No.___(SGH-7) shows the selected historical financial and operational
4 data attributed to the Spinco telecom properties as presented on page 19 of
5 Frontier's September 2009 S.E.C. Form S-4. Those data show generally similar
6 characteristics to the operational history of Frontier, with declining revenues and
7 income from continuing operations. Over the past two years (2007-2009),
8 Spinco's Revenues, Operating Income, and Income From Continuing Operations
9 have declined at 4.3 percent, 15.8 percent, and 11.3 percent, respectively. For
10 comparison, as noted above, those corresponding rates of decline over the past
11 two years for Frontier were 3.2 percent, 11.5 percent, and 22.4 percent,
12 respectively.
13 The historical operational data posted in the S-4 for Spinco shows that the
14 amount of capital spending has declined approximately 11 percent over the past
15 two years (as opposed to Frontier, with a reported two-year decline in
16 construction spending of 16.4 percent). Also, the data presented in the S-4 (and
17 shown in Exhibit No.___(SGH-7)) indicate that the Verizon Spinco properties
18 have historically contributed more in capital spending per revenue dollar than has
19 Frontier. According to those data, the Verizon Spinco properties contributed an
20 average of $0.15 to capital spending for every dollar of revenues over the 2004-
21 2009 period. Frontier, over that same period, reports that it has contributed $0.13
22 to capital spending per dollar of revenues.

1 If the reported historical Spinco data are accurate, they signify important
2 concerns for Frontier (concerns that Frontier does not address in its testimony in
3 this proceeding). As Frontier notes to its shareholders in the "Risk Factors"
4 section of its S.E.C. Form S-4 related to the pending merger,[16] it is concerned that
5 Verizon has under-invested in its Spinco assets and that upgrading the combined
6 company's infrastructure will require significant capital expenditures, including
7 "any expected or unexpected expenditures necessary to make replacements or
8 upgrades to the existing infrastructure of the Spinco business." Verizon's recent
9 deterioration of various service quality indicators in this jurisdiction, as addressed
10 by Public Counsel witness Barbara Alexander, would tend to confirm Frontier's
11 concern that Verizon has under-invested in its Spinco telecom assets.
12 However, the reported historical data for Spinco indicate that Verizon has
13 spent more on capital expenditures per dollar of revenues generated than has
14 Frontier over the past six years. Therefore, if Verizon has actually contributed
15 more in capital expenditures than has Frontier, and has not adequately maintained
16 its operations, then the level of capital spending necessary will not only be more
17 than Verizon has spent per dollar of revenue on average but much more than
18 Frontier has traditionally spent. To the extent, then, that Frontier's expectations
19 for capital expenditures for the combined company are based on Frontier's own
20 historical capital spending experience, those expectations would significantly
21 understate the expenditures necessary to maintain the system's current level of
22 operations, much less undertake any significant build-out of HSI infrastructure.

[16] *See*, Exhibit No.___(SGH-2), p. 10.

1 Understating expected or necessary capital expenditures would tend to make any
2 financial projection appear more robust (less risky) than it actually is.

3 **Q: In referring to the Spinco financial data, why do you say "if these data are**
4 **accurate"?**

5 A: Spinco doesn't really exist. While the people and equipment that constitute the
6 telecom properties that Verizon intends to spin off to Frontier are certainly real,
7 those aggregated operations referred to as Spinco have never existed as stand-
8 alone business unit within Verizon. Therefore, the financial statements that
9 represent Spinco's operations have to be "carved out" of Verizon's various
10 telecom operations (some of which are former GTE operations, some of which are
11 former Bell Atlantic operations such as West Virginia). In representing the
12 properties to be transferred as a single unit, the financial statements depend, to a
13 substantial degree, on the accounting assumptions and allocation processes
14 employed by Verizon management.

15 The notes that accompany Spinco's financial statements state:

> 16 Financial statements had not been historically prepared for
> 17 the Business [Spinco], as it was not operated as a separate
> 18 business and does not constitute a separate legal entity. The
> 19 accompanying combined special-purpose financial
> 20 statements have been prepared to present the statements of
> 21 selected assets, selected liabilities and parent funding, and
> 22 statements of income, parent funding and cash flows of the
> 23 Business in contemplation of a potential spin-off, or
> 24 business combination involving the Business. The
> 25 accompanying combined special-purpose financial
> 26 statements have been prepared in accordance with U.S.
> 27 generally accepted accounting principles using specific
> 28 information where available and allocations where data is
> 29 not maintained on a state-specific basis within the
> 30 Companies' books and records. *The allocations impacted*
> 31 *substantially all of the income statement items* other than

> operating revenues *and balance sheet items* with the exception of plant, property and equipment, accumulated depreciation and materials and supplies, which were maintained at the state level.[17]

Also, the accounting firm that audited the Spinco financial statements indicates:

> These financial statements and financial statement schedule are the responsibility of the Business' management. Our responsibility is to express an opinion on these financial statements based on our audits….
>
> The accompanying combined special-purpose financial statements were prepared on the basis described in Note 1 [see above quote re: allocations]. The combined special-purpose financial statements include allocations of certain indirectly attributable amounts on bases determined by management of the Business.[18]

In other words, Verizon (the party selling the assets) has provided financial statements for Spinco by allocating revenues, expenses, personnel, overhead, equipment, and capital to those properties. The audit confirms that the financial statements meet accounting standards, but those financial statements are based on the carve out allocations by Verizon which appear not to have been under review by the auditors. Moreover, the projected financials, which are largely the product of the seller's estimates, serve as (1) the basis for the valuation of the assets (the $8.6 billion price tag), and (2) the starting point for the financial projections for the future combined company.

As this Commission is well aware, any large, multi-factor accounting allocation process in which non-existent corporate operations are carved out is

[17] Frontier September 2009 S.E.C. Form S-4, Verizon's Separate Telephone Operations, Notes to Condensed Combined Special-Purpose Financial Statements, Note 1, p. F-68; emphasis added.
[18] Frontier September 2009 S.E.C. Form S-4, Report of Independent Auditors, Note 1, p. F-74.

1 necessarily dependent on many subjective assumptions that impact the results of
2 that allocation process. Because Verizon would benefit monetarily from making
3 assumptions or allocations in that process that lead to a higher valuation of those
4 assets (*e.g.*, higher revenues, lower operating expenses), and because the
5 transaction valuation and financial projections are grounded on those assumptions
6 and allocations, examining the efficacy of those allocations and the resulting
7 representation of Spinco financials would seem to be a reasonable course of
8 action. However, from my review, it appears that Frontier has undertaken no such
9 examination.

10 **Q: Can you provide an example of the uncertainty embedded in the Spinco**
11 **financial statements?**

12 A: Exhibit No.___(SGH-6) shows the Spinco financial data as presented in Frontier's
13 S.E.C. Form S-4. Those data show Spinco capitalized in 2009 with roughly 11.5
14 percent debt, which totals $624 million, and is comprised of four debentures
15 selected from the outstanding debt of Verizon's operating companies.[19] No
16 rationale for the selection of those debentures is provided. The other portion of
17 capital funding for Spinco is something called "parent capital," which is said to be
18 both debt and equity capital:

> 19 For purposes of these combined special-purpose financial
> 20 statements, some funding requirements have been
> 21 summarized as "Parent Funding" without regard to whether
> 22 the funding represents debt or equity. No separate equity
> 23 accounts are maintained for our business and debt
> 24 instruments that cannot be directly attributable to our

[19] Frontier September 2009, S.E.C. Form S-4, Report of Independent Auditors, Note 1, p. F-87.

1 business are allocated to us and included in the parent
2 funding.[20]
3
4 Therefore, the actual Spinco capital structure (% debt / % equity) is
5 unknown in the Spinco financials. If the "parent capital" were comprised of the
6 approximately 47 percent debt and 53 percent equity capital used by Verizon
7 Corporation to finance its operations over the past five years, Spinco's capital
8 structure would be essentially identical to Verizon Corporation's historical
9 average capital structure. However, Verizon's capital structure is very different
10 from the capitalization containing 11 percent debt shown in Spinco's financial
11 statements.
12 While the lack of a definitive capital structure for Spinco provides a
13 simple example of how Verizon management's assumptions can shape the
14 financial statements of the properties it intends to sell to Frontier, that particular
15 financial measure does not directly impact the valuation—the sale price.
16 However, as noted above, Verizon management's carve out allocation process
17 affects nearly all aspects of the Spinco income statement, and that has a very
18 direct impact on the value assigned to the firm. As noted in the opinions of
19 Frontier's financial advisors,[21] Spinco's projected 2010 Earnings Before Interest,
20 Taxes, Depreciation and Amortization (EBITDA) is a key element in determining
21 the $8.6 billion value of Spinco. The determination of Spinco's 2010 EBITDA is
22 based fundamentally on Verizon management's assumptions. Frontier's purchase
23 of Verizon's properties based on a valuation predicated on Verizon's estimates of

[20] Frontier September 2009 S.E.C. Form S-4, Note 7 to Spinco Financial Statements, p. F-90.
[21] *Id.,* at pp. 54-69.

1 Spinco's income statement, then, is similar to buying a house based on the seller's
2 asking price without an independent appraisal.

3 **Q: If the Applicants have agreed to a price for the Spinco properties and that**
4 **price has been deemed "fair" by their financial advisors, why should this**
5 **Commission be concerned whether or not that price may be inflated?**

6 A: First, a price that overstates the value of Spinco can have negative financial
7 consequences for the surviving firm. As noted previously, Frontier will add over
8 $3 billion in debt and have to issue another $5.3 billion in common equity to pay
9 Verizon for Spinco. Those additions to debt and equity have associated costs
10 (interest and dividends respectively). If operating cash flows are lower than
11 projections indicate, those additional operating costs assumed in buying Spinco
12 would reduce financial flexibility and perhaps prevent the new company from
13 carrying out intended capital additions necessary to help reduce revenue losses.
14 On the other hand, a lower sale price would reduce those financing costs and
15 increase financial flexibility.

16 With regard to the Spinco sale price, it is worth noting that in his well-
17 publicized comments regarding the future of telephony in the U.S.,[22] Mr. Ivan
18 Seidenberg, the CEO of Verizon, put very little value on "wired" operations such
19 as those Frontier is attempting to purchase here. That provides additional reasons
20 to question whether or not Frontier is simply paying too much for these assets.

[22] Saul Hansell, "Verizon Boss Hangs Up on Landline Phone Business," *New York Times Online*, Sept. 17, 2009, *available at* http://bits.blogs.nytimes.com/2009/09/17/verizon-boss-hangs-up-on-landline-phone-business/.

Second, the financial projections for the combined company are grounded on the projected 2010 income statement for Spinco, which is, as noted above, based on the allocation assumptions of Verizon management. If the Spinco EBITDA for 2010 is overstated, all the projected financial data for the combined company will indicate a more benign financial condition than will actually prevail in the future.

Third, the opinions of the Applicants' financial advisors are based on the unquestioned acceptance of the financial projections presented to them by Frontier and Verizon. Those financial projections are based not only on the Spinco financials but also on projections that assume very favorable outcomes in all aspects of the operation of the combined companies, which I will discuss in more detail subsequently. The financial advisors do not question or examine the assumptions in the financial projections and, in their disclosure statements, make very clear that their fairness opinion is based on the financial projections as presented by management—not on any independent appraisal. Evercore Group, LLC, one of Frontier's financial advisors, notes as follows regarding its fairness opinion:

> For purposes of its analysis and opinion, Evercore assumed and relied upon, without undertaking any independent verification of, the accuracy and completeness of all of the information publicly available, and all of the information supplied or otherwise made available to, discussed with, or reviewed by Evercore, and Evercore assumed no liability for such information. With respect to the projected financial data relating to Frontier and Spinco referred to above, Evercore assumed that they were reasonably prepared on bases reflecting the best currently available estimates and good faith judgments of the management of Frontier as to the matters covered thereby….

1 Evercore did not make or assume any responsibility
2 for making any independent valuation or appraisal of the
3 assets or liabilities of Frontier, Spinco or Verizon and was
4 not furnished with any such appraisals, nor did Evercore
5 evaluate the solvency or fair value of Frontier, Spinco or
6 Verizon under any state or federal laws relating to
7 bankruptcy, insolvency or similar matters.[23]
8
9 Frontier's other financial advisor, Citigroup Global Markets, and Verizon's
10 financial advisors, Barclays Capital and JP Morgan Chase, provide similar
11 statements regarding un-vetted reliance on management-provided financial
12 projections and lack of independent valuation appraisals.[24]
13 Fourth, all of the financial advisors have significant monetary incentive to
14 provide an opinion that the transaction is "fair" to stockholders. Both Evercore
15 and Citigroup disclose that Frontier will pay them $4 million up front for their
16 fairness opinion and $14 or $15 million more if the merger is finalized.[25] While
17 they do not disclose dollar amounts, Barclays and JP Morgan Chase indicate that
18 a substantial portion of the compensation for their fairness opinion is contingent
19 on completion of the merger, *i.e.* no fairness opinion, no substantial
20 compensation.
21 Fifth, this is a transaction initiated by Frontier, not Verizon.[26] As
22 discussed previously, Frontier's financial condition has deteriorated over the past
23 few years and this transaction seems to be necessary to shore up its financial well-
24 being. Verizon is a savvy deal-maker, as evidenced by FairPoint, Hawaiian
25 Telcom and Idearc—those properties are currently worth far less than Verizon

[23] Frontier September 2009 S.E.C. Form S-4, p. 55.
[24] *See* Verizon's Confidential Response to Public Counsel Data Request No. 127.
[25] Frontier September 2009 S.E.C. Form S-4, pp. 56, 59.
[26] *Id.* at p. 47.

1 received for them. That condition of a needy buyer and a savvy seller also
2 implies a sale price that may be overstated.
3 In summary, the Spinco valuations are predicated on the accounting
4 assumptions of the seller, which have been accepted without independent
5 appraisal by Frontier because Frontier needs this acquisition to shore up its
6 financial position, and the financial advisors have all deemed the transaction to be
7 "fair" based on unquestioned acceptance of the projections provided by Verizon
8 management and the promise of substantial compensation if the deal closes. It is
9 difficult to imagine even, for example, a small water utility getting regulatory
10 approval for the purchase of an asset un-appraised by the buyer at a price set by
11 the seller. Yet, in this $8.6 billion deal before the Commission, there appears to
12 have been very little vetting of the basic accounting assumptions or financial
13 projections on which it is based. I believe the lack of detailed independent review
14 in this transaction increases the likelihood that the transaction price is too high
15 and that circumstances different from those assumed in the valuation forecasts
16 could have negative financial consequences for the combined company if the
17 merger proceeds.
18 **Q: Has Frontier engaged an independent third party other than its financial**
19 **advisors to assess the condition or value of the Spinco properties it expects to**
20 **receive in this transaction?**
21 A: No. According to discovery responses to Public Counsel Data Requests Nos. 62,
22 63, 229 through 232, and 257, Frontier has not engaged a third party to evaluate
23 the properties it intends to purchase.

1 **Q: Does Frontier have any definite capital spending plans for the Verizon plant**
2 **it hopes to acquire in Washington?**
3 A: No. According to discovery responses, Frontier does not have any capital
4 spending plans in place for Washington.[27]
5 **Q: You noted that the financial advisors in this transaction receive considerably**
6 **more compensation if the merger is consummated. Are there other parties**
7 **involved in the merger that benefit monetarily from its completion?**
8 A: Yes. As noted on page 72 of the September 8, 2009 S.E.C. Form S-4, certain
9 officers of Frontier are entitled to certain payments if the merger is completed.
10 For example, Maggie Wilderotter, is entitled to receive $11.2 million if the
11 merger is completed. Ms. Wilderotter will assume the same position of the
12 surviving company if the merger is approved. In its S-4 report, Frontier notes that
13 stockholders should be aware that these payments create a potential conflict of
14 interest.
15 **B. Confidential Financial Projections**
16 **Q: Have you examined the Companies' financial projections?**
17 A: Yes.
18 **Q: What are your comments regarding those financial projections?**

[27] In the Joint Applicants' Response to Public Counsel Data Request No. 96 (c), which asked Frontier to provide the Company's financial model showing Frontier will be able to fulfill its broadband build-out commitments while, at the same time, service its current debt load as well as the additional debt assumed to finance the transaction, the company indicated that "No such model exists as Frontier has not made any specific broadband build-out commitments." In the Joint Applicants' Response to Public Counsel Data Request No. 208 the company indicated it "has not compiled a financial projection that isolates and analyzes fixed costs in Washington over the next five years." *See also*, Joint Applicants' Response to Public Counsel Data Request Nos, 196, and 209.

1 A: In response to Public Counsel Data Request No. 255, the Companies provided
2 their financial model for projections through 2014, which is the same financial
3 model provided their financial advisors and presented to the Board of Directors.
4 That model contains projections through 2014 for Frontier and Spinco on a stand-
5 alone basis as well as the projections for the combined company that include the
6 anticipated synergies. In order to gain a better understanding of the impact of the
7 proposed merger, I have taken those 2010-2014 projected data and combined
8 them with the 2004-2009 historical data provided in the S.E.C. Form S-4 and
9 provided my analysis in Exhibit Nos.___(SGH-5) and (SGH-7).
10 **[Begin Highly Confidential]** XXXXXXXXXXXXXXXXXXXXXXXXX
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[28] May 12, 2009 presentation to Frontier's Board by Citigroup and Evercore, Joint Applicants' Response to Public Counsel Data Request No. 35, Highly Confidential Attachment "WA PC Set1 FRO35, May 12 Report", p. 9.

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[29] The financial model provided by the Companies does not contain sufficient detail to be able to change assumptions regarding the operating factors mentioned, and it is not possible to quantify the revenue impact, for example, of a 2013 line loss rate of 10 percent rather than 7.9 percent. The model aggregates operating cost and those components of those costs cannot be accessed or changed.

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13 **XXXXXXXXXXXXXXXXX**

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XXXXXXXXXXXXXXXXX[31] **[End Highly Confidential]**

Q: You noted that Frontier may not be able to slow the revenue losses to the extent included in the financial projections. Are there other factors that could cause their revenues to decline at an even faster rate?

A: Yes. As previously noted, Frontier makes clear to its shareholders that the combined company will face competitive risks. The combined company will face intense competition, which could adversely affect it. Some of the combined company's future competitors will have superior resources, which may place the combined company at a cost and price disadvantage.[32]

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[30] May 12, 2009 Board presentation, *See* Joint Applicants' Response to Public Counsel Data Request No. 35, Highly Confidential Attachment "WA PC Set1 FRO35, May 12 Report", p. 11.

[31] Company financial model, Joint Applicants' Highly Confidential Response to Public Counsel Data Request No.255(b) and (c), using the following assumptions: Frontier share price = $7.00, WSR (Wall Street Research) Case, $500 million synergies, 9.5 percent cost rate of new debt.

[32] Frontier September 2009 S.E.C. Form S-4, p. 30.

1 While in the presentation to the Board, Frontier's financial advisors discuss
2 **[Begin Highly Confidential]** XXXXXXXXXXXXXXXXXXXXXXXXXXXX
3 XXXXXXXXXXXXXXXXXXXXXXX. **[End Highly Confidential]** The one
4 competitor with "superior resources" that is unmentioned is Verizon. Following
5 the sale of its local exchange properties in Washington and the other 13 states,
6 Verizon will be free to urge its former customers to "cut the cord" and eliminate
7 land-based communication in favor of wireless. Attached as Exhibit
8 No.___(SGH-8) is a copy of a letter sent by Verizon to landline customers, urging
9 them to "[s]implify your life and your budget by cutting the cord on your home
10 phone today."[33] It is reasonable to believe that such a letter coming from the
11 company that had been a customer's landline phone service provider urging them
12 to end that type of service would have an impact on Frontier's ability to maintain
13 that customer. Notably, the presentations to Frontier's Board of Directors
14 regarding the merger do not discuss potential competition from Verizon.
15 Therefore, it is quite possible that, due to competition, the reduction in the
16 rate of revenue decline forecast for the future may not be realized and, instead, the
17 rate of access line loss may accelerate from historical conditions, making the
18 future financial picture for a combined Frontier/Spinco more tenuous than now
19 forecast.

[33] "Verizon: Cut Your Landline To Save Money," DSLreports.com, July 2, 2009, *available at* http://www.dslreports.com/shownews/103232.

1 **Q: One of the key factors in Frontier's business plan is to increase high-speed**
2 **internet access availability to retain customers. Have you reviewed the**
3 **capital spending forecasts included in the Company's financial model?**
4 **[Begin Highly Confidential]**
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[34] Again, the 2009 data are estimated by annualizing the data reported at June 30, 2009. The May 12, 2009 report to Frontier's Board by its financial advisors **[Begin Highly Confidential]** XXXXXXXXXXX XXXXXXXXXXXXXXXXXXXX. [**End Highly Confidential]** *See* Joint Applicants' Response to Public Counsel Data Request No. 35, Highly Confidential Attachment "WA PC Set1 FRO35, May 12 Report."

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[35] *Id.* at p. 10.

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[36] Joint Applicants' Response to Public Counsel Data Request No. 35, Highly Confidential Attachment "WA PC Set 1 FRO35 May 1 Rpt", p. 19.
[37] Joint Applicants' Response to Staff Data Request No. 11, Hart-Scott-Rodino filing Attachment 4(c)(45).

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[38] Joint Applicants' Response to Public Counsel Data Request No. 35, Highly Confidential Attachment "WA PC Set1 FRO35, May 1 Report," p. 36.

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21 XXXXXXXXXXXXXXXXXX. [**End Highly Confidential]**

1 **Q: Has Frontier examined the "stress points" of its financial projections, that is,**
2 **at what point will increased line loss or increased capital expenditures**
3 **interfere with the combined company's ability to meet its fixed costs?**
4 A: Apparently not. When requested to produce such analyses, Frontier did not
5 produce any such documents or analyses, and instead cited their experience in
6 such matters. The data responses cited below are not confidential.

7 **Public Counsel Data Request No. 253**
8 Q: Has the Company performed a "stress test" on its
9 post-merger financial projections to examine what
10 impact greater-than-expected line loss or greater
11 than-expected capital expenditures or other adverse
12 factors could have on its ability to meet it fixed
13 costs? If so, please provide a complete copy of any
14 such contingency analysis; if not, please explain
15 why not.
16
17 A: As indicated in Frontier's response to Public
18 Counsel Data Request No. 205, there are many
19 variables that management must consider in
20 operating the business and that Frontier has
21 considered in preparing its projections associated
22 with the proposed transaction. Frontier forecasted
23 results based on historical trends and information
24 currently available that could influence future
25 results, and assessed risk based on where key
26 metrics (EBITDA %, dividend payout ratio as
27 examples) compare to target parameters.
28
29 **Public Counsel Data Request No. 258**
30 Q: In reviewing its financial projections related to this
31 acquisition, has Frontier undertaken any "stress
32 testing" of the assumptions on which that forecast is
33 based? For example, has Frontier examined its
34 ability to increase its HSI penetration if construction
35 expenditures necessary for Verizon telephone plant
36 are significantly higher than expected, or if line loss
37 is not abated by increased HSI availability, or if line
38 loss increases at a much faster rate than expected?
39 If so, please provide complete copies of any such

1 "stress test" or variance analysis; if not, please
2 explain why not.
3
4 A: Frontier has had significant experience in analyzing
5 and deploying High Speed Internet and increase
6 service availability and customer subscription to
7 service through competitive pricing and
8 promotional offerings. Frontier also has experience
9 in addressing various construction expenditure
10 requirements and line loss scenarios and responding
11 to these challenges.
12
13 **Q: Does this conclude your discussion of the Joint Applicants' financial model?**

14 A: Yes. As I have previously discussed, there are significant uncertainties in the
15 financial model that call into question its reliability and the ultimate reliability of
16 the financial predictions it makes. Spinco's earnings power and actual financial
17 history are not well-defined and, although Frontier admits to its stockholders that
18 there are a multitude of risks involved with the merger, the financial projections
19 on which the merger is based assume none of those risks come to pass and,
20 moreover, that *all* aspects of integration and operation of the Spinco properties go
21 very, very well. In a transaction this complex, that appears to be a low-
22 probability scenario and the realization of any one of a number of possible (even
23 probable) risks would result in a financial position less robust than that on which
24 the transaction is based.

25 While this transaction is different in some ways from the FairPoint
26 purchase of Verizon rural local exchange properties, the possibility of a similar
27 financial outcome is real. The financial health of FairPoint has declined to the

1 point where filed for bankruptcy protection on October 26, 2009.[39] Ratepayers are
2 also the ultimate recipients of the risks inherent in the transaction proposed by
3 Frontier and Verizon. As noted above, there are difficulties with many of the
4 assumptions and projections underlying this merger, indicating that the risks to
5 ratepayers are greater than they would be if the merger is denied. I recommend
6 the merger, as currently written, be denied.

7 ## IV. CONDITIONAL RECOMMENDATIONS

8 **Q: If the Commission elects approve the proposed transaction, what measures**
9 **do you recommend be included as conditions to approval?**

10 A: One of the big question marks in this transaction is the current condition of the
11 Verizon local exchange telephone plant. Verizon has been very clear in its
12 testimony in this proceeding as well as its discovery responses that its corporate
13 focus has not been on the properties it intends to sell to Frontier.[40] Frontier even
14 warns its stockholders that one risk of this transaction relates to the condition of
15 the Spinco properties it hopes to buy because, with regard to those properties,
16 Verizon has invested at a "significantly lower" rate than has Frontier.[41] Yet
17 Frontier, perhaps too eager to acquire the cash flows associated with these
18 properties, has not sought any independent assessment of the condition or value of
19 the properties. Verizon's service quality problems in Washington tend to confirm
20 that local exchange infrastructure investment by Verizon has been lacking.[42]

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[39] Joan E. Solsman, "FairPoint Enters Chapter 11 Protection in Deal Giving Control to Lenders," *Wall Street Journal,* Oct. 26, 2009, *available at* http://online.wsj.com/article/SB10001424052748704335904574496942316622698.html.
[40] Direct Testimony of Timothy McCallion, p. 5.
[41] Frontier September 2009 S.E.C. Form S-4, p. 34.
[42] *See* DirectTestimony of Barbara R. Alexander for more details related to Verizon's service quality.

1 Finally, Verizon's own engineers admit that the Verizon local exchange telephone
2 infrastructure requires substantial investment.[43]

3 It appears likely then that the capital spending requirements necessary for
4 a combined Frontier/Spinco to undertake the build-out promised in its testimony
5 will exceed the levels included in its financial forecasts due, in part, to the lack of
6 historical capital spending by Verizon. Because of that fact, I recommend that, as
7 a condition of approval of this merger, this Commission require Verizon to
8 contribute at least $600 million to Frontier to assist with necessary capital
9 spending in Washington. That could occur with either a cash transfer from
10 Verizon to Frontier or by a $600 million reduction in the $3.3 billion cash transfer
11 currently planned from Spinco to Verizon prior to the merger. Because
12 Washington represents approximately 12 percent of the Spinco properties (based
13 on its share of total access lines), the application of that condition in this
14 jurisdiction will be $72.4 million. I believe that this contribution should be in
15 addition to the $40 million Verizon escrow account that Dr. Roycroft
16 recommends.

17 As I noted previously in my testimony, unless the wording currently in the
18 merger agreement is changed, any merger condition that requires a monetary
19 contribution from Verizon will simply add the amount related to the condition to
20 the $8.6 billion price tag for the deal, and Frontier (and its ratepayers) will
21 ultimately be responsible for those additional costs. Therefore, in order for a
22 condition requiring any monetary contribution from Verizon to help the surviving

[43] Joint Applicants' Response to Staff Data Request No. 11, Hart-Scott-Rodino filing Attachment 4(c)(45).

1 corporation, it must, I believe, be coupled with a co-condition: (1) that the
2 Applicants agree any such payment cannot be defined as a "Required Payment
3 Amount" as set out in Paragraph 1.144 of the Merger Agreement, *and* (2) that the
4 total amount of equity contribution will be $5.247 billion. I am not an attorney
5 and do not know if there are other means in the merger agreement by which
6 Verizon can avoid any conditional cash contributions. If there are, those avenues
7 for avoiding regulatory intent should also be eliminated. However, if this
8 Commission elects to condition this transaction on additional monetary
9 contributions by Verizon, the parties must agree to change the wording of the
10 merger agreement, which, as written, calls for any such requirements to be the
11 ultimate responsibility of Frontier, not Verizon.
12 As a final part of this condition—because it is designed to support capital
13 spending for the surviving company, I recommend that the Commission require
14 Frontier to monitor those funds and use them only for improving the telephone
15 plant they are purchasing from Verizon. In other words, those monies are
16 designed to supplement the capital spending on the Verizon properties and, as a
17 condition of approval, Frontier should ensure through quarterly reporting to the
18 Commission that those additional funds contributed by Verizon are being used
19 only to improve the newly-acquired plant facilities and not to be spent on
20 facilities located in Frontier's current service territory.
21 **Q: Do you have other recommendations or conditions you believe the**
22 **Commission should adopt if it does decide to approve the transaction?**

1 A: Yes. I have one other recommended condition to the merger. Until the post-
2 merger company is able to achieve an investment-grade bond rating, Frontier
3 should be required to payout dividends that are no greater than its earnings. As
4 noted in my prior discussion of Frontier's historical financials, that company has
5 not accomplished that task in the past. As a result the common equity portion of
6 its capital structure has dwindled to a level below 10 percent of total capital.
7 Even if the capital structure of the surviving firm is improved with a successful
8 offering of a huge amount of stock, if Frontier continues to pay dividends that
9 exceed its earnings post-merger, it will whittle away its financial strength. That
10 would, ultimately, not be beneficial for ratepayers.

11 **Q: Does this conclude your direct testimony, Mr. Hill?**

12 A: Yes, it does.