

**BEFORE THE WASHINGTON STATE  
UTILITIES AND TRANSPORTATION COMMISSION**

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

**RESPONSIVE TESTIMONY OF  
CHARLES W. KING**

On Behalf of  
**THE UNITED STATES DEPARTMENT OF DEFENSE**  
And  
**ALL OTHER FEDERAL EXECUTIVE AGENCIES**

November 3, 2009

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Application, June 29, 2000, ¶30.



1 **Q. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY IN**  
2 **REGULATORY PROCEEDINGS?**

3 A. Yes. Attachment B is a tabulation of my appearances as an expert witness before  
4 state and federal regulatory agencies. It shows that I have testified before the  
5 public utility commissions of over 40 states, including Washington, and I have  
6 appeared before all federal agencies that regulate telecommunications, utilities,  
7 transportation and postal services.

8 **Q. FOR WHOM ARE YOU APPEARING IN THIS PROCEEDING?**

9 I am appearing on behalf of the consumer interests of the Department of Defense  
10 (“DoD”) and all other Federal Executive Agencies (“FEA”) in Washington.

11

12 **INTERESTS OF DoD/FEA**

13

14 **Q. WHY HAS DoD/FEA INTERVENED IN THIS CASE?**

15

16 A. The Department of Defense and all other Federal Executive Agencies have a  
17 substantial presence in the State of Washington. Total federal employment in all  
18 Washington State, both civilian and active military, is about 100,000 personnel.  
19 Major military facilities include Fort Lewis, McChord Air Force Base, the Puget  
20 Sound Naval Shipyard, and the Whidbey Island Naval Air Station.

21

1 This case involves the transfer of the Washington exchanges and associated long  
2 distance services of Verizon Communications Inc.'s subsidiary, Verizon  
3 Northwest ("Verizon") to Frontier Communications Corporation ("Frontier").  
4 Verizon serves approximately 578,000 access lines in a large area around Puget  
5 Sound and north and east of Seattle, along with some smaller territories elsewhere  
6 in the state. The exchanges in these areas will transfer to Frontier under the  
7 proposed plan.

8  
9 The Verizon exchanges to be transferred to Frontier include those on the  
10 Canadian border where the Federal government has customs and immigrations  
11 offices. Also, DoD has several major military installations and facilities in the  
12 service areas that will be transferred. These include the Whidbey Island Naval  
13 Air Station, an active military installation that includes a hospital, Navy electronic  
14 warfare and patrol squadrons, support facilities for various Navy activities, and a  
15 center for Navy and Marine Corps reserve training. The "official"  
16 telecommunications services at Whidbey Island are procured under a federal  
17 contract that will not be subject to the Verizon-to-Frontier transfer. However,  
18 there are numerous "unofficial" lines to base housing and concessionaires that  
19 will be transferred. It is therefore vital to Federal end users that the transition  
20 from Verizon to Frontier be made seamlessly and without degradation of service  
21 quality or efficiency.

1           Moreover, the DoD/FEA interest goes beyond the locations directly affected by  
2           the transition. Most DoD and FEA telecommunications services are procured  
3           under contract through competitive bidding procurement. The effectiveness of  
4           the competitive procurement process is, of course, dependent upon there being a  
5           number of financially strong and technically capable entities that can submit bids.  
6           It is therefore important to the DoD/FEA that the Washington successor to  
7           Verizon, the second largest telecommunications company in the nation, be a  
8           viable, financially sound and technologically sophisticated company that will be  
9           able to bid competitively in Federal telecommunication procurements, not just in  
10          its own service territory, but throughout the state.

11  
12          Additionally, the successor to Verizon will be a wholesale provider of services  
13          and facilities to competitive retail telecommunications providers. The service  
14          quality performance, the practices, and the operations of this successor must  
15          support effective competition among carriers in providing services to contract  
16          customers and the general public in Washington.

17  
18          Unfortunately, the record of two recent Verizon spin-offs has not been  
19          encouraging.

20  
21          **PREVIOUS VERIZON SPIN-OFFS**

22  
23          **Q.     WHAT PREVIOUS VERIZON SPIN-OFFS ARE YOU REFERRING TO?**

1

2 A. Recently, there have been two major Verizon landline spin-offs. The first was the  
3 sale of Verizon's Hawaiian landline assets to The Carlyle Group ("Carlyle"). The  
4 second was the sale of Verizon's northern New England wireline operations to  
5 FairPoint Communications ("FairPoint").

6

7 **Q. PLEASE DESCRIBE THE HAWAIIAN TELEPHONE TRANSACTION.**

8

9 A. The Hawaiian Telephone Company was created in the 1880's under the laws of  
10 the Kingdom of Hawaii. In the mid-20th century it was acquired by General  
11 Telephone and Electronics, later the GTE Corporation. It became part of the  
12 Verizon family of companies when Verizon acquired GTE in the 1990s. In 2004,  
13 Verizon sought approval to sell its Hawaiian assets to Carlyle, a private equity  
14 enterprise. Carlyle created a new entity, Hawaiian Telcom, Inc. ("HT"), to  
15 provide the local exchange services previously offered by Hawaiian Telephone.  
16 The applicants in that case stated that after the transition HT "will have the  
17 financial fitness and ability to fund the continuing operations of Verizon Hawaii  
18 through the revenue generated from the existing and proposed operations."<sup>1</sup>  
19 Likewise, the applicants stated that they ". . . acknowledge the importance of  
20 ensuring a seamless transition for customers and have conducted a rigorous  
21 process to select a world-class systems integrator to replicate the full functionality

---

<sup>1</sup> Application, Docket No. 04-0140, June 21, 2004, pp. 13-14.

1 of the systems currently provided by Verizon.”<sup>2</sup> In 2005, the Hawaii Public  
2 Utilities Commission (“HPUC”) approved the transfer subject to numerous  
3 conditions.<sup>3</sup>

4  
5 In its decision approving the sale, the HPUC stated that it would initiate an  
6 investigation of HT’s service quality approximately six months after HT assumed  
7 the back-office operations that Verizon previously provided on a national basis to  
8 all of its service territories, including Hawaii. This service quality proceeding,  
9 HPUC Docket No. 2006-0400, confirmed that the transition from Verizon was far  
10 from seamless or harmless to customers. Although the HPUC has not yet  
11 rendered a decision in that proceeding, it is undisputed that for more than a year  
12 following the cutover from Verizon’s back-office operations, HT was unable to  
13 collect data – even manually – as to six service standards for which the HPUC  
14 required reports.<sup>4</sup> Thus, the full extent of the problems associated with the  
15 transfer could not even be quantified.

16  
17 As to the seven service standards for which HT was able to file reports, five dealt  
18 with call answering time. HT’s ability to answer calls was lacking compared to  
19 the experience under Verizon. For example, during the nine months following the  
20 cut-over, HT’s percent of residential installation and billing office calls answered  
21 in 20 seconds ranged from a low of 8.01 percent to a high of 70.37 percent,

---

<sup>2</sup> *Id.*, p. 15.

<sup>3</sup> Docket No. 04-0140, Decision and Order No. 21696, March 16, 2005.

<sup>4</sup> HT’s Post-Hearing Brief, HPUC Docket No. 2006-0400, filed November 9, 2007 at p. 118, note 101. The missing reports included crucial data such as the percent of trouble reports cleared within 24 hours, the percent of installation and repair commitments met and customer trouble reports per 100 lines.



1 compared to the objective of 85 percent and Verizon's 2005 percentage of 87.46  
2 percent. Likewise, the answering time achieved for business installation and  
3 billing office calls following the cut-over ranged from 12.83 percent to 78.82  
4 percent compared with the objective of 85 percent and Verizon's achieved rate of  
5 88.23 percent.<sup>5</sup> In an effort to repair the damage caused by the non-functioning  
6 systems, HT had to replace the contractor working on the transition.<sup>6</sup>

7  
8 HT admitted in its pleadings that service suffered as a result of the transition from  
9 Verizon and that it created erroneous bills and was unable to handle adequately  
10 incoming calls.<sup>7</sup> HT candidly admitted that "... the cutover did unfortunately  
11 create some negative impacts on its customers."<sup>8</sup> Finally, HT agreed with the  
12 assessment of the Consumer Advocate that its "... retail customers following  
13 cutover experienced long waiting times to reach [its] contact center, extremely  
14 slow and long transaction processing times, high levels of fall out, long waiting  
15 times to repair, missed or delayed installation and repair commitments and billing  
16 errors."<sup>9</sup>

17  
18 The cutover from Verizon's back-office operations also caused significant  
19 problems for HT's wholesale customers. One Competitive Local Exchange  
20 Carrier ("CLEC"), Time Warner Telecom of Hawaii, L.P. ("TWTC"),  
21 summarized the problems as follows:

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<sup>5</sup> HT's February 15, 2007 Statement of Position, HPUC Docket No 2006-0400, pp. 39-41.

<sup>6</sup> *Id.*, pp. 74-77.

<sup>7</sup> *Id.*, pp. 53-57.

<sup>8</sup> HT's August 31, 2007 Final Position Statement, HPUC Docket No. 2006-0400, p. 21.

<sup>9</sup> *Id.*, p. 7.

1 HT's conversion to its new back office systems was a failure by any  
2 measure. Immediately following cutover, virtually none of the  
3 wholesale back office systems were functioning. Today, 19 months  
4 after cutover, they are still not functioning at the same level as the  
5 Verizon systems. Although HT has made significant progress in  
6 addressing its issues, those efforts are not complete.

7  
8 HT violated the Merger Decision and the Stipulation by failing to  
9 provide the same or similar functionality for wholesale service as  
10 previously provided by Verizon, and by failing to remain on the  
11 Verizon systems until HT's new systems were fully tested and  
12 operational. These violations significantly harmed TWTC and HT's  
13 other customers.<sup>10</sup>

14  
15 In summary, the applicants in the Hawaii sale promised a seamless transition to  
16 HT's back-office systems, but the record in that case – including HT's own  
17 pleadings -- shows that both wholesale and retail customers suffered significantly  
18 from the failure of automated systems, dropped calls, long call answering and  
19 holding times, billing errors and costly manual efforts to correct the deficiencies.  
20 HT was not able to track repair and installation times, so that data for these  
21 critical service quality metrics could not even be assessed in determining the  
22 adverse effects of the transition to HT's systems.

23  
24 On December 1, 2008, HT filed for Chapter 11 bankruptcy protection.<sup>11</sup> The  
25 public explanation for the bankruptcy was the impending inability to refinance its

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<sup>10</sup>Time Warner Telecom of Hawaii, L.P., dba Oceanic Communications' Post-hearing Brief, HPUC Docket No. 2006-0400, November 9, 2007, p. 2. (footnote omitted). The text of the brief contains a detailed description of HT's numerous failures in connection with providing wholesale service after acquiring the Verizon exchanges, and the adverse impact that the failures had on Time Warner and its customers. Another CLEC, Pacific LightNet, Inc., filed a Post-hearing Brief asserting that the flawed transfer of operations caused it to incur additional expense to resolve interconnection problems and billing errors.

<sup>11</sup> See Hawaiian Telcom Communications, Inc., Securities and Exchange Commission Form 8-K filed December 1, 2008, and HT's December 1, 2008 Press Release contained in that filing.

1 debt, but the costs and lost customers resulting from HT's poor service quality  
2 probably contributed to the Company's inability to service its debt.

3  
4 **Q. PLEASE DESCRIBE VERIZON'S SALE OF NEW ENGLAND**  
5 **OPERATIONS TO FAIRPOINT.**

6  
7 A At the beginning of 2007, FairPoint was an incumbent local exchange  
8 telecommunications company with about 330,000 access lines. In that year,  
9 Verizon New England, Inc., FairPoint, and affiliated firms announced a planned  
10 \$2.4 billion transaction, generally similar to that proposed in Washington, under  
11 which FairPoint would obtain Verizon's landline businesses in Maine, New  
12 Hampshire and Vermont.

13  
14 The proposed transaction was controversial and the implementation of the sale  
15 was seriously flawed. In Vermont, for example, the Public Service Board initially  
16 denied the application. The petitioners submitted a revised proposal in which  
17 they improved the transaction from the standpoint of ratepayers in several ways.  
18 The revised proposal bettered FairPoint's financial standing after the acquisition  
19 by substantially reducing the initial debt and decreasing dividends. In addition,  
20 the proposal was revised to include a Performance Enhancement Plan, which was  
21 designed to prompt more investment and improve service quality by mandating  
22 that FairPoint set aside funds when it fails to meet certain specified service  
23 standards. Also, FairPoint agreed to an independent monitor of the transition

1 from Verizon's systems to its own, with the objective of making the transition  
2 more seamless and further safeguarding consumers.<sup>12</sup>

3  
4 The Vermont Public Service Board approved the transfer with additional  
5 conditions on February 15, 2008.<sup>13</sup> Following the transaction, there began a series  
6 of "cutover" problems that are still not fully resolved. Indeed, service  
7 deteriorated to the extent that the Board called for an investigation into whether  
8 the Company should be allowed to continue its operations in the state if it cannot  
9 overcome its customer service, billing and operational problems.<sup>14</sup>

10  
11 On July 1, 2009, FairPoint's new CEO, David Hauser, candidly acknowledged  
12 that FairPoint's reputation has been damaged by operational problems following  
13 the takeover of Verizon's northern New England landline telephone and Internet  
14 business. Attachment C to this testimony is a complete copy of Mr. Hauser's  
15 statement.

16 On October 26, 2009, eight days before the filing of this testimony, FairPoint  
17 announced that it had filed for Chapter 11 bankruptcy protection.<sup>15</sup>

18 **Q. WHAT IS THE LESSON FROM THESE PREVIOUS VERIZON SPIN-**  
19 **OFFS?**

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<sup>12</sup> Vermont Public Service Board Docket No. 7270, Order entered February 15, 2008.

<sup>13</sup> *Id.*

<sup>14</sup> Vermont Docket No. 7270 Information Page at <http://www.state.vt.us/psb/document/>. This testimony has focused on Vermont, but the problems exist in the other states as well. For example, on July 29, 2009, the *Bangor Daily News* reported that the Maine Public Utility Commission refused to waive the financial penalties that FairPoint had incurred for poor service performance.

<sup>15</sup> FairPoint Form 8-K, filed with the Securities and Exchange Commission, October 26, 2009.

1 A. Both the Hawaii and the FairPoint transactions were described as seamless and of  
2 no harm to consumers, much as this transaction in Washington has been described  
3 by Frontier and Verizon. Events proved otherwise in each case. In view of this  
4 history, this Commission must view with great suspicion any statements by  
5 Verizon and Frontier that there will be no impact on customers from the transfer.

6  
7 I therefore believe it is important that this Commission establish safeguards to  
8 ensure that the difficulties that arose in these previous spin-offs will not be  
9 repeated in Washington.

10  
11 **OBJECTIVE OF THIS INTERVENTION**

12  
13 **Q. DO YOU OPPOSE THIS TRANSACTION?**

14  
15 A. As it is now structured, I do. However, with adequate and focused safeguards  
16 such as I will describe in this testimony, this transaction could be in the public  
17 interest. As Frontier's witness states in his testimony, Frontier is a rurally  
18 oriented local exchange carrier with many years of experience.<sup>16</sup> It appears eager  
19 to expand the scope of services offered in Washington, particularly high-speed  
20 Internet service. To deny this transaction would be to require Verizon to continue  
21 to serve exchanges it would prefer to exit and customers it would prefer not to

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<sup>16</sup> Direct Testimony of Daniel McCarthy, page 4.

1 have. This would not be a prescription for reliable, efficient and responsive  
2 telecommunications service.

3  
4 **Q. WHAT, THEN, IS YOUR CONCERN IN THIS PROCEEDING?**

5  
6 A. I am concerned that the transition from Verizon to Frontier be as seamless as  
7 possible and that there be no rate increases, disruptions, or other service quality  
8 losses arising from this transaction. In this testimony, I recommend several  
9 conditions that should be imposed on Frontier and Verizon as part of the approval  
10 of the transaction. If these two companies are prepared to meet the commitment  
11 they have made to transparency and seamlessness, then these conditions should be  
12 altogether painless.

13  
14 These conditions relate to two principal areas of concern to DoD/FEA. The first  
15 is the financial health of the Washington operation. The second is the  
16 maintenance of adequate service quality in the Washington exchanges.

17  
18  
19 **FINANCIAL HEALTH OF WASHINGTON OPERATIONS**

20  
21 **Q. WHY ARE YOU CONCERNED ABOUT THE FINANCIAL HEALTH OF**  
22 **THE WASHINGTON OPERATIONS?**

1 A. Some historical numbers describing Frontier will explain this concern:

2

<b>Frontier Communications</b>						
	2004	2005	2006	2007	2008	6 Mos. 2009
Earnings per Share	\$0.23	\$0.60	\$1.06	\$0.65	\$0.57	\$0.20
Dividends per Share	\$2.50	\$1.00	\$1.00	\$1.00	\$1.00	\$0.50
<u>Book Capital Structure:</u>						
Long-term Debt (\$000)	4,266,998	3,999,376	4,467,086	4,736,897	4,721,685	4,944,989
Equity (\$000)	1,362,240	1,041,809	1,058,032	997,899	519,045	448,161
Total Capital (\$000)	5,629,238	5,041,185	5,525,118	5,734,796	5,240,730	5,393,150
<u>Percentages</u>						
Long-term Debt	75.8%	79.3%	80.9%	82.6%	90.1%	91.7%
Equity	24.2%	20.7%	19.1%	17.4%	9.9%	8.3%
Total Capital	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

3

4 Source: Frontier SEC Forms 10-K and 10-Q.

5

6 This table demonstrates that Frontier has repeatedly issued dividends well in  
7 excess of its net income with the result that the equity portion of its capital  
8 structure has declined from an already low level of 24.2 percent in 2004 to only  
9 8.3 percent as of June 30, 2009.

10

11 Frontier has promised to reduce its post-transaction dividend to \$0.75 per share.  
12 Unless earnings per share improve dramatically, this reduction will still result in a  
13 dividend greater than net income. A \$0.75 dividend is more than 30 percent  
14 greater than the Company's 2008 earnings per share. Moreover, as of the second  
15 quarter of 2009, Frontier's earnings are down significantly from 2008.

16

1 As a result of this over-generous dividend policy, Frontier's stock price, currently  
2 at about \$7.20 per share, is over four times its book value. Even at the reduced  
3 dividend of \$.75, the dividend yield is close to 10 percent. This very high  
4 dividend yield indicates that investors have little expectation of further stock  
5 appreciation, not a good harbinger for the future.

6  
7 This strategy of paying shareholders in excess of the Company's earnings is  
8 unsustainable. The book value of Frontier's equity is now only about eight  
9 percent of the total asset value of the Company. Thanks to Frontier's very  
10 generous treatment of its shareholders, the market value of its equity is  
11 considerably higher, so that its market capitalization (as opposed to book  
12 capitalization) is about 35 percent equity. But Frontier cannot continue  
13 indefinitely to issue dividends greater than its net income because otherwise its  
14 book equity will be wiped out altogether. Either Frontier must dramatically  
15 increase its earnings per share or it must reduce further its dividend. If the  
16 Company reduces its dividend, the market value of its stock will likely decline  
17 and the Company will become severely over-leveraged.

18  
19 Frontier must change its ways; otherwise it will be unable to raise further capital.  
20 Even now, Frontier bears an S&P rating of BB, below the level acceptable for  
21 investment by pension and benefit funds. Any further deterioration of Frontier's  
22 financial condition will constrain Frontier's access to both debt and equity capital,



1 and that will threaten the investments that Frontier has indicated that it will make  
2 in its newly acquired Washington exchanges.<sup>17</sup>

3  
4 **Q. WHAT WILL BE THE EFFECT OF THIS TRANSACTION ON**  
5 **FRONTIER'S HEALTH?**

6  
7 A. Frontier is absorbing an entity more than twice its size:<sup>18</sup>

	<u>Frontier</u>	<u>Verizon Lines ("SpinCo")</u>
8 Lines	2,254,333	4,790,673
9 Revenues (Millions)	\$2,137	\$4,287

10  
11  
12 There are important financial and service implications from his relationship. The  
13 principal financial implication is that Frontier's balance sheet and income  
14 statement will be very significantly impacted by the debt/equity mix and  
15 profitability of the newly acquired exchanges. In the near term, the impact will be  
16 quite positive thanks to the financial strength of the acquired assets. The  
17 approximately 60 percent (\$5,247 million) of the value of the transferred assets  
18 (\$8,580 million) will take the form of a transfer of equity. Verizon will create a  
19 temporary corporation, termed "SpinCo," the stock of which will be distributed to  
20 Verizon's existing shareholders. That stock will then be transferred to Frontier,  
21 so that each Verizon shareholder will become a shareholder in Frontier. This is a  
22 tax-free transaction for Frontier, Verizon and Verizon's shareholders. The

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<sup>17</sup> On September 29, 2009, Fitch, one of the bond rating agencies, reported that it had evaluated 30 companies with what it termed "junk bond" ratings. It found that Frontier was among the three companies most in danger of breaching lender requirements. On September 30, Fitch clarified that this assessment was based on the pre-merger condition of Frontier and that the merger will improve that condition.

<sup>18</sup> Presentation of Frontier Communications at the Barclays Capital Worldwide Wireless and Wireline Conference, May 2009, pages 19 and 24.

1 remaining 40 percent (\$3,333 million) will be debt (or debt relief) that the new  
2 entity, SpinCo, will pay to Verizon.<sup>19</sup>

3  
4 The result of this transaction will be a Frontier that is considerably less leveraged  
5 than the existing company. Its equity proportion of total market capitalization  
6 will increase from 35 percent to 49 percent, and its debt proportion will fall  
7 correspondingly from 65 percent to 51 percent. The ratio of net debt to Earnings  
8 Before Interest, Taxes, Depreciation and Amortization (“EBITDA”) will decline  
9 from 3.8 times to 2.2 times. Other ratios will improve as well, although not quite  
10 so dramatically. For example, the ratio of EBITDA to total revenue will increase  
11 from 54.3 percent to 55.7 percent, and the free cash flow per share of stock will  
12 increase from \$1.58 to \$1.75.

13  
14 **Q. WILL THESE IMPROVED FINANCIAL RATIOS ALLEVIATE YOUR**  
15 **CONCERN ABOUT FRONTIER’S FINANCIAL HEALTH?**

16  
17 **A.** No. I am concerned that this improvement in Frontier’s financial condition will  
18 serve merely to perpetuate the past pattern of paying shareholders more than the  
19 earnings of the Company. Unless Frontier is willing to limit its dividends to the  
20 level of earnings per share, it will again erode its ability to raise capital for the  
21 investments needed to expand services to its customers in Washington.

22  

---

<sup>19</sup> *Id.*, pages 15 and 19.

1 Q. WHAT CAN THE WASHINGTON COMMISSION DO ABOUT THIS  
2 SITUATION?

3  
4 A. I doubt that the Washington Commission is interested in micro-managing  
5 Frontier, or that it wishes to dictate the nation-wide financial policies of the  
6 Frontier Communications Corporation. The Commission's focus is on  
7 telecommunications services in Washington.

8  
9 The Washington exchanges transferred from Verizon to Frontier will be served by  
10 a Frontier subsidiary successor to Verizon Northwest. That subsidiary will  
11 certainly prepare balance sheets, income statements and cash flow statements for  
12 the subsidiary as a whole and for its Washington operations. The income  
13 statements will identify the income for the previous year. The cash flow  
14 statements will identify the dividends that the subsidiary pays to its parent.

15  
16 I recommend that the Commission take two actions to protect the financial  
17 integrity of the Washington operations. The first is to replicate the limitation that  
18 was embodied in the Settlement among CenturyTel, Inc., Embarq Corporation,  
19 the Commission Staff and the Public Counsel when CenturyTel and Embarq  
20 merged. That limitation, found in paragraph 2a of the Agreement, was as follows:

21  
22 2.a. For three (3) years from the close of the merger, at any time when the  
23 condition in subsection 2.a.i exists, the Merged Company ILECs will limit  
24 payments of dividends on common equity distributed to CenturyTel [the surviving  
25 parent], or any other subsidiary or affiliate of CenturyTel, in any year to an  
26 amount not more than 50 percent of net income in the prior fiscal year. The

1 Merged Company ILECs will limit payment of dividends on common equity in  
2 any quarter, if dividends are distributed quarterly, to not more than one-fourth of  
3 the annual limitation amount.

4  
5 i. The average market value of CenturyTel's common equity is less than  
6 50 percent of the book value of CenturyTel's net debt. The average  
7 market value of CenturyTel's common equity will be calculated by  
8 multiplying the average stock price by the average number of fully-diluted  
9 common stock shares outstanding during the preceding 120 calendar day  
10 period. As used in this section, "net debt" means total long-term debt less  
11 cash. This test will be calculated prior to the determination of each  
12 declaration of dividends by the Merged Company ILECs, whether  
13 quarterly, special, or other.<sup>20</sup>

14  
15 The second action is to tie the resolution of the two concerns I have with this  
16 transaction -- financial and service quality -- together. The Commission can  
17 condition any dividend from the Washington operations on their meeting the  
18 safety and service quality standards set forth in WAC-480-120-401 through -560.  
19 This provision will help keep Washington secure from any raid by the parent  
20 companies on the cash generation of the Washington operations when it is clear  
21 that further Washington investments are needed. This provision, too, should  
22 remain in effect for at least three years following the closing of the transaction.

23  
24 These two requirements can be enforced by periodic audits described in the  
25 CenturyTel/Embarq Settlement Agreement, the reports required by WAC 480-  
26 120-439, and the application of the Commission's existing general powers to  
27 enforce its rules and orders.

28  
29 **Q. ARE THERE ANY PRECEDENTS FOR THESE REQUIREMENTS?**

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<sup>20</sup> Settlement Agreement dated April 22, 2009, and approved with modifications in WUTC Order 05, Docket UT-082119, May 28, 2009.

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21

A. Yes. As noted, the first restriction – no dividends in excess of net income -- was imposed on CenturyTel and Embarq as a condition of their merger. As regards the second restriction – no dividends if service quality is inadequate – there is precedent relating directly to Frontier. Last year, Frontier, the New York Commission Staff and the Consumer Protection Board signed an agreement whereby Frontier’s New York subsidiary would not be allowed to issue dividends to its parent if its service quality fell below certain levels specified in the agreement. This provision was among a number of conditions relating to finances, corporate governance and reporting. It replaces a much more restrictive regime known as the “Open Market Plan” that was adopted when the Rochester Telephone Company merged with other corporate entities to form Frontier Communications.<sup>21</sup>

**Q. ARE THERE ANY OTHER CONCERNS REGARDING FRONTIER’S FINANCES?**

A. Yes. As I have noted, the \$0.75 dividend that Frontier proposes to pay to its shareholders still exceeds its 2008 earnings per share by about 30 percent, and it appears it may exceed 2009 earnings by a yet larger margin. Frontier is therefore under fairly severe pressure to increase its earnings. This pressure could result in

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<sup>21</sup> A copy of this agreement is Attachment D to this testimony.

1 a campaign of rate increases that would burden ratepayers who remain dependent  
2 on Frontier's landline telephone services.

3  
4 **Q. WHAT CAN THE COMMISSION DO TO AVERT THIS OUTCOME?**

5  
6 A. Verizon is subject to rate base/rate-of-return regulation in Washington, and  
7 presumably the Frontier subsidiary will be regulated similarly once the transfer is  
8 made. This means that the Commission can exert its authority to allow rate  
9 increases only when they are tied to legitimate cost increases. Among the costs  
10 that the Commission should not allow are those associated with this transaction.  
11 By "associated with this transaction" I mean not just the legal and accounting  
12 costs of implementing the transaction, but also any other cost increases such as  
13 the added costs of duplicating Verizon's systems and protocols and cost increases  
14 arising from changes in the operations and the financial condition of the  
15 Washington subsidiary. Since those costs would not be incurred were the  
16 exchanges still with Verizon, they are not the ratepayers' responsibility. Other  
17 costs that are not ratepayers' responsibility are the higher debt and equity returns  
18 that may result from Frontier's over-leveraged condition and from the transfer  
19 from a company with an S&P rating of A to one with a rating of BB.<sup>22</sup> In  
20 addition, the Commission should transfer from Verizon to Frontier the revenue  
21 imputation for directory services that it adopted in Docket No. UT-061777.<sup>23</sup>

22  

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<sup>22</sup> This limitation was embodied in Section 2c of the CenturyTel/Embarq Settlement Agreement.

<sup>23</sup> WUTC Docket No. 061777, Order 01, Initial Order Approving and Adopting Settlement Agreement, June 30, 2008; Notice of Finality July 21, 2008.

1 **SERVICE QUALITY CONCERNS**

2

3 **Q. WHY ARE YOU CONCERNED ABOUT THE SERVICE QUALITY**  
4 **RESULTING FROM THIS TRANSACTION?**

5

6 A. As noted earlier in my testimony, the two recent large Verizon spin-offs have  
7 resulted in severe service quality degradation. I am concerned that this pattern not  
8 be repeated in Washington following the Verizon-to-Frontier transition. This  
9 concern is amplified by the following service quality indicators published by the  
10 Federal Communications Commission ("FCC"):

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	<u>Nationwide</u>		<u>Washington</u>	
	Frontier	Verizon	Verizon	VZ-Contel
1. <u>Installation Interval (days)</u>				
Business Lines	5.9	1.9	2.2	1.7
All Lines	5.6	1.7	1.2	0.9
2. <u>% Local Installation Commitments Not Met</u>				
Business Lines	4.3%	2.8%	3.5%	2.6%
All Lines	3.7%	1.7%	2.3%	2.2%
3. <u>Trouble Reports per Month per 100 Lines</u>				
Business Lines	1.58	0.77	0.51	0.59
All Lines	2.78	1.63	0.97	0.96
4. <u>Complaints to Regulatory Agencies</u> (Per Million Lines)				
Business Lines	112	50	30	47
All Lines	352	350	111	71
5. <u>Repeat Out of Service Trouble Reports as a Percentage</u> <u>Of Initial Out of Service Trouble Reports</u>				
Business Lines	13.4%	13.7%	10.8%	8.8%
All Lines	16.9%	15.5%	11.1%	9.8%
6. <u>Out of Service Repair Interval (hours)</u>				
Business Lines	21.3	18.9	15.5	15.0
All Lines	24.2	35.5	25.4	21.8

Source: 2008 FCC ARMIS 43-05 Reports

In every case but two, Frontier scores worse nationally than Verizon nationally. In every case but one, Verizon performs better in Washington than Frontier does nationally, and that one is only marginally better than one of the two Verizon operations in Washington, Verizon and Verizon Contel.

These comparisons do not bode well for the service quality that can be expected following the transfer of Verizon’s Washington operations to Frontier. They are of particular concern given that Frontier has no existing operations in Washington and will be entering the state for the first time. Frontier will be operating with previous employees of Verizon, as well as Verizon’s protocols and Information



1 Technology systems with which Frontier's management and staff will not be  
2 familiar.

3 **Q. FRONTIER WITNESS McCARTHY ARGUES THAT FRONTIER WILL**  
4 **NOT ENCOUNTER THE SERVICE PROBLEMS THAT PLAGUED THE**  
5 **TWO PREVIOUS VERIZON SPIN-OFFS. WHAT IS YOUR RESPONSE?**

6 A. Mr. McCarthy's position is that Frontier is already a substantial operating  
7 company with established billing, operational and customer service systems in  
8 place. Furthermore, for the previous Verizon exchanges in all states except West  
9 Virginia, these back-office functions will be handled through a data center in Ft.  
10 Wayne, Indiana that is designed to replicate Verizon's back-office system. Only  
11 later – possibly much later -- will Frontier transition these functions onto its own  
12 software and hardware systems. According to Mr. McCarthy, this plan will  
13 ensure that Frontier's new service territories will be transferred seamlessly and  
14 without any deterioration in service quality.

15 I very much hope Mr. McCarthy is correct. However, the reality is that Verizon's  
16 billing, operating and customer service systems are not the same as Frontier's, and  
17 if Frontier is to have uniform systems nationwide, it will eventually have to cut  
18 the Verizon protocols over to its systems. As I have noted, in previous cases this  
19 cutover has proved to be difficult, costly and highly disruptive to both retail and  
20 wholesale customers.

21 Another concern relates to planning. In response to a data request in the West  
22 Virginia proceeding parallel to this one, Frontier stated that it had no detailed

1 capital budget for the year 2010.<sup>24</sup> This is ominous because most utility  
2 companies have capital budgets five years out. If Frontier has no plan for capital  
3 expenditures, the Commission should question the seriousness of its promise to  
4 increase greatly the proportion of Washington subscribers with access to the  
5 Internet.<sup>25</sup>

6 For these reasons, it is important for the Washington Commission to monitor  
7 Frontier's service performance. To be a deterrent against service degradation, the  
8 Commission should be prepared to impose sanctions if service performance  
9 deteriorates.

10  
11 **Q. DOES THE WASHINGTON COMMISSION HAVE ESTABLISHED**  
12 **SERVICE QUALITY STANDARDS FOR TELECOMMUNICATIONS**  
13 **SERVICE?**

14  
15 **A.** Yes. WAC 480-120-401 through 480-120-560 contain safety and service quality  
16 standards for most categories of local exchange telephone service. For example,  
17 WAC 480-120-438 contains the standard for trouble reports. WAC 480-120-440  
18 provides standards for repairs for service interruptions and impairments. WAC  
19 480-120-439 contains the service quality reporting requirements.

20  
21  
22  

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<sup>24</sup> Attachment E is a copy of this data request and its response.

<sup>25</sup> Joint Application of Verizon and Frontier to the WUTC, May 29, 2009, ¶28.

1 **SANCTIONS FOR POOR PERFORMANCE**

2

3 **Q. DOES THE COMMISSION HAVE THE POWER TO ENFORCE THESE**  
4 **STANDARDS?**

5

6 A. Yes. WAC 480-120-019 provides as follows:

7

8 The commission may enforce the performance requirements set forth in this  
9 chapter by imposing administrative penalties under RCW 80.04.405, 80.04.380,  
10 or other appropriate penalty statutes.

11

12 **Q. WHAT ADDITIONAL ENFORCEMENT MECHANISMS COULD YOU**  
13 **SUGGEST IN ADDITION TO THOSE CURRENTLY IN THE RULES?**

14

15 A. As an initial step, I have already recommended that as a condition of approving  
16 the transaction, the Commission adopt the mechanism currently in place for  
17 Frontier in New York State. If the service quality metrics currently being  
18 reported to the Commission fall below those specified in WAC 480-120-400 to  
19 500 series during any quarter, then the Frontier subsidiary operating in  
20 Washington will be precluded from issuing dividends to its parent in the  
21 following quarter. Of course, the Commission can excuse the Company from  
22 these provisions if it can demonstrate that it was not responsible for the failure to  
23 achieve the service quality thresholds.

24

1   **Q.    ASIDE FROM DIVIDEND RESTRICTIONS, WHAT FURTHER**  
2       **SANCTIONS SHOULD THE COMMISSION IMPOSE IN ORDER TO**  
3       **ENSURE ADEQUATE SERVICE QUALITY?**

4

5    A.    There are three types of sanctions which the Commission can impose for poor  
6        service quality:

7

8        1.    Require annual credits to the bills of all Frontier customers for Frontier's  
9            failure to meet service standards state-wide for a consecutive number of  
10           months, or for a total number of months during a year.

11

12       2.    Impose a fine on Frontier, payable to the Commission or to the state  
13            treasury, as appropriate, for its failure to meet service quality standards for  
14           a certain consecutive or total monthly period during a year.

15

16       3.    Require credits to Frontier's customers on a customer-by-customer basis  
17            for failure to meet a Commission-mandated provisioning or restoration  
18           standard in a particular instance, with a credit applied to the bill following  
19           the failure.

20

21        The first approach would provide an incentive to Frontier to provide service  
22        according to the prescribed standards. The disadvantage, however, is that the  
23        annual credit is spread over the general ratepayer base and may be seen as

1 inadequate for customers who experienced severe problems. Moreover, because  
2 the credit is annual, a customer who experienced problems may have moved or  
3 changed carriers by the time that the credit is issued. In that respect, the benefit is  
4 received by new customers whose service was not affected negatively. The  
5 approach would be of value in a situation where service problems are extended  
6 and severe, and the credit is large in amount, because the action would heighten  
7 public awareness of the carrier's service deficiencies and bring pressure to  
8 improve.

9  
10 The second approach – payment of penalties for failure to meet service standards  
11 – has merit as an incentive to the carrier to meet the designated service criteria.  
12 The approach, however, provides no compensation to customers who received  
13 poor service. Rather, it is a punishment that reduces the carrier's earnings and  
14 generates negative publicity if the fine is issued in a significant amount.  
15 Frontier's failure to provide service quality reports for an extended period is the  
16 type of situation that this approach should encompass. This approach could be  
17 combined with the prior approach in egregious situations to preserve the  
18 Commission's processes and orders while making whole the affected customers.

19  
20 Arguably most appropriate is the third approach – immediate credits to individual  
21 customers' bills. Customers who do not receive the quality of service according  
22 to the standard that the Commission specifies should not be expected to pay full  
23 price for what they received. This approach – which has been adopted elsewhere

1 for both retail and wholesale customers – provides a financial incentive for  
2 Frontier to provide high quality service, and the beneficiaries of the credit are the  
3 individual customers who suffered. Importantly, the immediate nature of the  
4 credit guarantees that the customer directly affected receives the full benefit of  
5 Frontier’s obligation to redress service failures.

6  
7 **Q. YOU HAVE NOTED THAT THE COMMISSION HAS THE POWER TO**  
8 **IMPOSE FINES, BUT ARE THERE ANY PROVISIONS IN PLACE FOR**  
9 **CUSTOMER CREDITS?**

10  
11 **A** Verizon’s tariff contains some limited provisions for customer credits. Section  
12 2.C.7.d, part of the General and Local Exchange Tariff, contains a “Service  
13 Performance Guarantee” which states that if an installation or repair “is not  
14 completed as agreed” Verizon will credit a business \$100 and a residence \$25.  
15 Section 2.C.7.e states that if a customer is without service for more than 24 hours,  
16 Verizon will give a prorated credit for the outage time, except in cases of *force*  
17 *majeure*. Frontier has committed to continue all Verizon tariffs unchanged.<sup>26</sup>

18  
19 **Q. CAN YOU RECOMMEND ANY FURTHER CUSTOMER**  
20 **GUARANTEES?**

21  

---

<sup>26</sup> *Id.*, ¶4.

1 A. Yes. I recommend the customer guarantees and credits that were set forth in  
2 paragraph 30 of this Commission's order in Docket No. UT-991358 approving the  
3 merger agreement between US WEST and Quest.<sup>27</sup> A copy of these provisions is  
4 Attachment F to this testimony.

5

6 **FURTHER PROTECTIONS**

7

8 **Q. ARE THE SAFEGUARDS YOU HAVE RECOMMENDED FULLY**  
9 **ADEQUATE TO PROTECT CUSTOMERS FROM SERVICE**  
10 **DETERIORATION?**

11

12 A. No. The safeguards I have recommended are probably adequate so long as  
13 Frontier is a healthy, fully functional provider of local exchange  
14 telecommunications services. But if Frontier's financial condition deteriorates in  
15 similar manner as Hawaiian Telcom and FairPoint have deteriorated, these  
16 protections will be of little value from the customers' standpoint. The limitations  
17 on dividend payments would be irrelevant when there is little or no net income  
18 from which to pay dividends. The fines and credits for poor service would offer  
19 little incentive to improve performance when there is no money to fund the  
20 improvements. Indeed, the sanctions would only aggravate the Company's  
21 deteriorating financial condition.

22

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<sup>27</sup> Docket No. UT-991358, Ninth Supplemental Order Approving and Adopting Settlement Agreements and Granting Application, June 29, 2000.

1 **Q. HOW MIGHT THE COMMISSION SAFEGUARD CUSTOMERS**  
2 **AGAINST THE POSSIBILITY OF FRONTIER'S BANKRUPTCY?**

3  
4 A. If Frontier's financial condition deteriorates, it will likely be the result of the  
5 failure of the back-office functions to perform properly. That was certainly the  
6 case on the Hawaiian Telcom and FairPoint spin-offs. Except in West Virginia,  
7 the back-office systems that might fail will be the legacy of Verizon. Verizon is  
8 currently preparing a data center in Fort Wayne, Indiana that will either replicate  
9 or provide access to Verizon's own back-office programs and systems. That  
10 center will be turned over to Frontier when this transaction is consummated.  
11 Subsequently, Frontier will probably transition the functions provided through  
12 this center into its own back-office operations.

13  
14 One of the more disturbing aspects of this transaction, as with the previous  
15 transactions, is the extent to which Verizon walks away from it after it is  
16 consummated. Once the transfer is completed, Verizon will take no further  
17 responsibility for the performance of the Fort Wayne data center or the services it  
18 will provide. For a very substantial fee, Verizon will "maintain" the facility, but  
19 Verizon has made no commitment to guarantee its performance or to compensate  
20 Frontier for failures in the center's operations.

21  
22 I recommend that the Commission challenge Verizon's lack of responsibility for  
23 the performance of the data center. The Commission should require that Verizon



1 continue its involvement with the data center and with Frontier's performance in  
2 general. The length of that involvement would depend on the effectiveness of  
3 Frontier's operations, management and financial arrangements. Only when  
4 Frontier has demonstrated that it can provide adequate service to its customers in  
5 Washington should the Commission let Verizon "off the hook" for its former  
6 operations in the state. This commitment by Verizon should also continue until  
7 all of its systems and programs have been transitioned over to Frontier's own  
8 back-office operations.

9  
10 There are a variety of ways that this involvement could be maintained. Among  
11 the possibilities are:

- 12 • Require Verizon to operate its legacy systems until they are integrated into  
13 Frontier's own systems.
- 14 • Require Verizon and Frontier jointly to plan and execute any cutover of  
15 former Verizon systems to Frontier's systems, take joint responsibility for  
16 any necessary corrective actions, and assume joint liability for sanctions  
17 that may be imposed for service problems resulting from the cutover.
- 18 • Require Verizon to compensate Frontier for failures of its legacy systems.
- 19 • Require Verizon to retain a portion of the stock in "SpinCo" that it would  
20 otherwise distribute to its shareholders.
- 21 • Condition the transfer of the Washington operating authority on Frontier's  
22 performance and financial health so that if conditions deteriorate, the  
23 authority reverts to Verizon.

- 1           •       Prior to the integration of any back-office operation into Frontier, require a  
2                    third party certification that it fully replicates all functionalities provided  
3                    by the Verizon system(s) it will replace.<sup>28</sup>

4  
5           Each of these alternatives could involve significant operational, financial and  
6           possibly legal complications. For this reason, I do not specifically recommend  
7           any one of these approaches. I do recommend, however, that the Commission  
8           require the joint parties to devise terms and conditions acceptable to both that will  
9           maintain Verizon's involvement and responsibility through the integration of  
10          Verizon's systems into those of Frontier. Such a plan should be filed for  
11          Commission approval after interested parties have had an opportunity to provide  
12          comments.

13

14    **SUMMARY OF RECOMMENDATIONS**

15

16    **Q.     PLEASE SUMMARIZE YOUR RECOMMENDATIONS.**

17

18    **A.     In this testimony, I have recommended that :**

---

<sup>28</sup> In approving this transaction, the South Carolina Public Service Commission imposed the condition that Frontier notify it of each change or replacement of former Verizon systems and provide it assurance that all systems have been tested and certified before any irreversible cutover is made. South Carolina Public Service Commission Docket No. 2009-220-C, Order No. 2009-769 Approving Transfer of Assets, Authority, and Certificates, October 29, 2009, p. 21, decretal ¶10. h.

- 1       •     The Commission impose the same dividend limitations on the Frontier  
2            successor to Verizon Northwest as were imposed in the merger of  
3            CenturyTel and Embarq.  
4
- 5       •     For at least the first three years following the closing of the transaction, if  
6            any of the service quality metrics in the Commission's rules consistently  
7            fall below their prescribed level during any quarter, then the Frontier  
8            subsidiaries operating in Washington be constrained from issuing  
9            dividends to their parent company in the following quarter.  
10
- 11      •     In any rate case involving Frontier, the Commission disallow all costs  
12            associated with the transaction and any added return to capital resulting  
13            from the lower credit rating of Frontier relative to Verizon.  
14
- 15      •     The Commission transfer to Frontier the revenue imputation for directory  
16            services that it adopted in Docket No. UT-061777.  
17
- 18      •     If service quality deteriorates following the merger, the Commission  
19            consider imposing fines for each failure to achieve the performance  
20            measures listed in its rules.  
21

1           •     The Commission adopt the customer credit terms and conditions that were  
2                   embodied in its order approving the merger agreement between US WEST  
3                   and Quest.

4  
5           •     The Commission direct the parties to the transaction to develop terms and  
6                   conditions whereby Verizon retains responsibility for performance of its  
7                   legacy systems through the integration of those systems into those of  
8                   Frontier.

9  
10

11   **Q.    DOES THIS COMPLETE YOUR TESTIMONY?**

12

13   A.    Yes. It does, although I should note that there are some aspects of this transaction  
14           that I have not addressed. These include such issues as the likelihood of cost  
15           savings from the transaction or the quality of the broadband services that Frontier  
16           offers. My silence on such issues does not mean that they are not important to  
17           DoD/FEA or that DoD/FEA will not address them later in this proceeding.