Rebuttal Testimony of David R. Whitehouse
Exhibit No. __ (DW-15T)

BEFORE THE

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Joint Application of	)	
Verizon Communications Inc. and	)	
Frontier Communications Corporation	)	
For An Order Declining to Assert	)	Docket No. UT-090842
Jurisdiction Over, or, in the Alternative,	)	
Approving the Indirect Transfer of	)	
Control of Verizon Northwest Inc.	)	

REBUTTAL TESTIMONY OF

DAVID R. WHITEHOUSE

SENIOR VICE PRESIDENT AND TREASURER

ON BEHALF OF

FRONTIER COMMUNICATIONS CORPORATION

November 19, 2009

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1 I. **INTRODUCTION**

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

3 A. My name is David R. Whitehouse. I am Senior Vice President and Treasurer of
4 Frontier Communications Corporation ("Frontier"). My business address is 3
5 High Ridge Park, Stamford, Connecticut, 06905.

6

7 **Q. Please provide a brief history of your educational and employment**
8 **background.**

9 A. I received a Bachelor of Science degree in Finance from Penn State University
10 and a Master of Business Administration from the Harvard University Graduate
11 School of Business. I began my career as a Financial Analyst for General Electric
12 ("GE") Capital Corporation where I was in the GE Financial Management
13 Training Program. I then worked with J.P. Morgan & Co. in the Mergers and
14 Acquisitions Advisory Group. Immediately prior to joining Frontier, I was
15 Treasurer of International Paper Company ("International Paper"), the world's
16 largest paper and forest products company, with more than $20 billion in annual
17 revenue. In that position, my primary responsibilities included capital structure
18 analysis, capital markets activities, corporate borrowings, structured finance, and
19 Rating Agency management. While at International Paper, I executed an
20 extensive number of financing transactions totaling more than $20 billion on
21 behalf of the company.

22

1 **Q. What are your responsibilities as Senior Vice President and Treasurer for**
2 **Frontier?**
3 A. I have overall responsibility for Treasury, Investor Relations, Facilities & Real
4 Estate, and Pension investments. My primary function is to oversee Frontier's
5 current $4.8 billion debt portfolio and to take responsibility for all Treasury
6 matters related to Frontier. These include the development of our capital structure
7 strategy, banking relations, capital sourcing, cash management and Treasury
8 operations, and management of our relationship with the Rating Agencies.
9
10 **Q. Did you file direct testimony in Case No. UT-090842?**
11 A. No. I did not.
12
13 **Q. What is the purpose of your testimony?**
14 A. I am providing financially-based rebuttal to the direct testimonies of: 1) William
15 H. Weinman, on behalf of Washington Utilities and Transportation Commission
16 ("WUTC" or "Commission") Staff ("Staff")[1]; 2) Mr. Robert T. Williamson, on
17 behalf of Staff[2]; 3) Ms. Jing Liu, on behalf of Staff[3]; 4) Dr. Trevor R. Roycroft,
18 on behalf of Washington Public Counsel ("Public Counsel")[4]; 5) Mr. Stephen G.

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[1] Direct Testimony of William Weinman, on behalf of WUTC Staff (hereafter "Weinman").

[2] Direct Testimony of Robert T. Williamson, on behalf of WUTC Staff (hereafter "Williamson").

[3] Direct Testimony of Jing Liu, on behalf of WUTC Staff (hereafter "Liu").

[4] Direct Testimony of Trevor R. Roycroft, Ph.D., on Behalf of Public Counsel, November 3, 2009, Highly Confidential Version (hereafter "Roycroft Confidential").

1 Hill, on behalf of Public Counsel[5]; and 6) Mr. Charles W. King, on behalf of the
2 United States Department Of Defense and All Other Federal Executive
3 Agencies.[6]
4
5 **Q. Can you summarize your testimony?**

6 A. Yes. In response to financially-based arguments made by the Staff and other
7 intervenor witnesses, I will testify regarding three general subjects: (i) purported
8 financial "risks" related to Frontier and the proposed transaction; (ii) questions
9 arising from the intervenors' questions about Frontier's projected financials,
10 including the company's model; and (iii) proposed financial conditions, including
11 the possibility of renegotiating the terms of the merger agreement between
12 Frontier and Verizon Communications Inc. ("Verizon").

13 • **Frontier is a financially sound operator, committed to diverse areas,**
14 **including suburban, small urban and rural area.** In terms of its financial
15 profile and expected operating performance, Frontier will be one of the
16 financially strongest non-Regional Bell Operating Company ("RBOC")
17 incumbent local exchange carriers ("ILECs") in the country after the
18 consummation of this transaction. I assert that the evidence is clear that there
19 is relatively little risk, there is no evidence of demonstrable harm that will
20 result from the proposed transaction, and there is considerable evidence that

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[5] Direct Testimony of Stephen G. Hill, On Behalf of Public Counsel, November 3, 2009 (hereafter "Hill").

[6] Responsive Testimony of Charles W. King, On Behalf of The United States Department Of Defense and All Other Federal Executive Agencies, November 3, 2009 (hereafter "King").

1 the combined company will be one of the most financially sound ILECs in the
2 U.S. This evidence is responsive to Staff's concerns that Frontier is not
3 financially strong enough to "make necessary improvements to local
4 telephone facilities and widen deployment of broadband access" in
5 Washington.[7] I will refer to the Verizon Separate Telephone Operations,
6 including Washington and the other 13 states in which Verizon is transferring
7 its local assets, as "VSTO" throughout this testimony. I will show that the pro
8 forma company is expected to have better credit metrics than does Qwest and
9 all of the other major independent ILECs except CenturyLink (the combined
10 and renamed CenturyTel Inc. ("CenturyTel") and Embarq Corporation
11 ("Embarq"). I will also explain that the Commission should focus primarily
12 on cash flow generation when evaluating Frontier's financial status, which
13 provides the most important evidence of the combined company's financial
14 capacity. As it does for Frontier today, cash flow in the combined
15 Frontier/VSTO properties is expected to provide ample funding for operating
16 expenses, capital expenditures, service of debt, and payment of dividends to
17 equity-holders. While Staff and other intervenors assert that Frontier is not as
18 financially strong as Verizon, a more careful analysis of the facts makes it
19 clear that Frontier is among a limited number of carriers that have the
20 financial resources combined with the strategic intention to invest capital to
21 serve low-density regions like those in the VSTO areas. Furthermore, the
22 Commission should understand that diversified carriers, such as Verizon, have

[7] Weinman, p. 4, lines 1-2.

1 a fiduciary obligation to prudently direct their capital resources toward
2 strategic growth objectives like wireless, which generated 69% of Verizon's
3 third quarter 2009 cash flow, with which other Verizon operations such as the
4 lower-density local exchange operations of VSTO must compete for capital.
5 Frontier's strategic commitment to its markets, including the Washington
6 VSTO areas, is clear and without strategic conflicts, and the proposed
7 transaction will produce demonstrable public benefits for Washington
8 customers as set forth in my testimony. I will also explain that Staff has
9 assumed incorrectly that credit ratings lower than Verizon's can be equated
10 with "harm" to Washington customers, and I will assert that the appropriate
11 tests of Frontier's financial capacity involve the company's demonstrated
12 ability to invest, to maintain regulated rates, to meet service quality standards,
13 to access and support debt and equity funding requirements, and to dedicate
14 levels of capital investment that will benefit a larger number of customers in
15 the Washington VSTO service region.

16 • **Questions raised by certain intervenors about Frontier's projection**
17 **model in terms of revenue expectations, cost management and capital**
18 **investment are unfounded.** I will demonstrate that Frontier has engaged in
19 appropriate due diligence to assess the revenues, expenses, potential
20 synergies, and capital investment required to serve customers in Washington
21 and the other VSTO service areas. As such, Frontier's expectations for the
22 future financial performance of the combined company, as reflected in the

1 projection model, are reasonable and based on the company's extensive
2 experience acquiring and integrating ILEC properties. The company's
3 projections certainly should be given considerably more weight than the
4 criticisms of parties who offer no evidence to the contrary and who possess no
5 experience in acquiring, integrating and operating a telecommunications
6 company.

7 • **Proposed financial conditions are unnecessary.** Because there is no
8 likelihood of demonstrable harm resulting directly from the proposed
9 transaction, no financial conditions are required for Commission approval.
10 However, if the Commission determines that conditions are necessary, those
11 conditions should be imposed only to respond to clear and definable *harms*
12 that might result from this transaction. I emphasize that speculative *risks*
13 should not be the basis for onerous or costly new obligations that exceed the
14 standard of protections already imposed on Verizon or other Washington
15 ILECs. Frontier is willing to accept certain requirements proposed by the
16 Staff, but cannot agree to conditions proposed by intervenors that would
17 require renegotiation of the merger agreement between the company and
18 Verizon, or that would have material negative impacts on the company's
19 financial health and flexibility.

20

21 II. FRONTIER IS AND WILL REMAIN A FINANCIALLY SOUND 22 OPERATOR.

1 **Q. How do you understand Staff's financially-related objections to the approval**
2 **of the transaction?**
3 A. Staff lead witness Weinman testifies that "substantial harm would result from the
4 transfer of control."[8] Mr. Weinman then cites various risks and attempts to
5 translate the purported risks into actual "harms." However, nowhere does Mr.
6 Weinman provide evidence of the likelihood of specific "harm." I will explain
7 that harms are not the same as risks, and that many situations involving risk
8 generate substantial benefits without resulting in actual harm. I agree with
9 Frontier witness, Daniel McCarthy, that this transaction has financial and other
10 characteristics that make it very similar to the CenturyTel-Embarq transaction that
11 was recently approved by this Commission. Turning to Staff witness Weinman's
12 testimony, he recites specific risks related to a lack of verifiable data, the expected
13 financial performance of Frontier, and the financing issues associated with the
14 application.[9] Mr. Weinman then explains that the Staff recommends denial of the
15 proposed transaction based on twelve reasons which I presume can be grouped
16 under the three specific risk categories he identifies. Mr. Weinman's regrouped
17 purported risks from the proposed transaction are the following:
18 A. Perceived lack of verifiable data
19 - Reason 4—data requests imply that Frontier has not done enough to
20 investigate the condition of the VSTO plant.
21 - Reason 12—Frontier lists S-4 risk factors which cannot be assessed or
22 resolved from the testimony or the responses to the data requests.
23 B. Expected financial performance

[8] Weinman, p. 3, line 18.

[9] Weinman, p. 5, lines 9-12.

1 • Reason 1—Frontier has a lower debt rating than that of Verizon, which
2 will result in higher cost to Washington customers.
3 • Reason 2—Increased debt costs from the transaction will likely result
4 in higher equity costs to Washington customers.
5 • Reason 3—Verizon has a broader product line which helps offset line
6 losses.
7 • Reason 8—Risk factors indicate that the projected financial results
8 could be affected.
9 • Reason 11—Merger synergies will not provide any benefit to
10 Washington customers.
11 C. Financing issues
12 • Reason 5—The merger agreement requires that Frontier issue more
13 equity if regulatory agencies require that Verizon make additional
14 financial contributions.
15 • Reason 6—Frontier will be constrained from offering equity for two
16 years after the transaction's close date.
17 • Reason 7—Frontier is paying dividends that exceed earnings per share.
18 • Reason 9—Frontier is not able to give "adequate" interest rate
19 estimates for the $3.3 billion in additional debt.
20 • Reason 10—Frontier is not able to articulate the debt covenants that
21 would be associated with the $3.3 billion in new debt.
22
23 **Q. Will you address these "risks" in your testimony?**
24 A. Yes. I will use Staff witness Weinman's issues to organize my responses, first
25 based on the perceived verifiable data, then the expected financial performance of
26 the combined company, and the "financing issues." I will group the financial

1 performance and financing issues into a single section, as Frontier's ability to
2 raise financing and the terms of that financing are inextricably linked to how the
3 company is performing from a fundamental perspective.
4
5 **A. Perceived Lack of Verifiable Data**
6
7 **Q. How do you respond to the Staff which contends that Frontier has not**
8 **performed enough analysis of the condition of the Verizon plant?**
9 A. Staff witness Weinman speculates, in his Reason 4, that the due diligence
10 performed by Frontier was not "enough," but Mr. Weinman does not specify what
11 standards he applied to support his conclusion, or the basis for those standards.[10]
12 Mr. McCarthy provides a fuller response to this issue, but I emphasize that
13 Frontier had access to significant and sufficient information; arguably more
14 information than the company had prior to its other successful acquisitions. The
15 results of that review were considered by Frontier and its advisors and their
16 conclusions were shared with senior management. In short, Frontier believes that
17 its due diligence process for the proposed transaction was thorough and effective,
18 was consistent with industry practice, and provided the company with sufficient
19 data to responsibly move forward with the transaction. Mr. McCarthy and Mr.
20 Smith provide more detail on this matter.
21

[10] Weinman, p. 5, lines 25-28.

1 **Q. Can you comment about the assertion by Staff witness Weinman that**
2 **Frontier lists S-4 "Risk Factors" and other cautionary statements which**
3 **cannot be assessed or resolved from the testimonies or the responses to the**
4 **data requests in this proceeding?**
5 A. Yes. The Staff, Mr. Hill, and Dr. Roycroft all assert general comments about
6 risks and "Risk Factors" in regulatory filings, but there is no specific evidence
7 that any of these risks will result in real harms.[11] I note that there are questions
8 about certain issues in the testimonies of the Staff and intervenors, but no material
9 evidence was provided anywhere in those testimonies in response to Frontier's
10 detailed analyses. Again, Mr. McCarthy will provide more detail in his
11 testimony, but I assert that the factors compiled in the S-4 represent a catalog of
12 potential developments that might or might not occur. As Mr. McCarthy
13 explains, there is no probability associated with the risks that are recited in the S-
14 4. The Securities and Exchange Commission requires a company with publicly
15 traded securities to list all the potential "risks" such as market factors, the
16 potential that financing will not be available, the possibility that another bidder
17 will emerge, and so on. Frontier is prepared to address any specific risk factors
18 that are concerns for the Staff or other intervenors, and I will respond in the
19 testimony below with respect to the specific issues raised by Mr. Weinman, Staff
20 and other intervenors. However, in response to Mr. Weinman's Reason 12,[12] it is
21 not appropriate to respond to generalized "risks" as broadly summarized in the S-

[11] *See*, for example, Weinman, pp. 19-22; Hill, p. 6, line 22 through p. 11, line 23; Roycroft, p. 27, lines 21 ff.

[12] Weinman, p. 6, lines 16-18.

1 4 for security holders when the likelihood of those "risks" ever materializing has
2 in no way been demonstrated by Staff or the intervenors to result in harm to
3 Washington customers.
4
5 **B. Expected Financial Performance and Financing Issues**
6 **Q. Do you agree with the representations of Staff witnesses that Frontier may**
7 **not be fit to acquire the VSTO properties and specifically the Washington**
8 **operations?**[13]
9 A. No, I do not. As Frontier has affirmed repeatedly, a foundational rationale of the
10 pending transaction for Frontier is to strengthen the financial position of the
11 company, and to sharpen the strategic focus of the combined Frontier and VSTO
12 to serve customers in lower-density areas. Confirming this view, credit rating
13 agencies and analysts have gone on record to confirm that the financial
14 characteristics of the combined company are positive as a result of this
15 combination, as has been described previously by Frontier's Chief Operating
16 Officer, Daniel McCarthy.[14] More directly, the result of that financial strength
17 will be improved services for Frontier's customers, including those in

[13] *See*, for example, Weinman, p. 3, line 20 through p. 4, line 2: "The failure of the companies to offer adequate consumer benefits or protections puts customers at risk of being served by a company without enough financial strength to make necessary improvements to local telephone facilities and widen deployment of broadband access." See, also, Roycroft, p. 55, lines 2 ff.

[14] Prepared Direct Testimony of Daniel McCarthy, on Behalf of Frontier Communications Corporation, July 9, 2009 (hereafter "McCarthy Direct"), p. 39, lines 2-5; Exhibit No. __ DW-23, Moody's Investors Service, Global Research Rating Action: Frontier Communications Corporation (May 13, 2009), and Exhibit No. __ DW-17, Fitch Ratings, Fitch Places Frontier Communications on Rating Watch Positive (May 13, 2009). Mr. Hill argues that the rating agencies have not indicated that they will assign investment grade ratings to the post-transaction company; he is correct, but no rating agency ever indicates such a change (aside from Positive Watch, which is the case here) before the change in rating occurs; see Hill, p. 21, lines 18 ff.

1 Washington, who will benefit from new products and services, from a service
2 provider strategically focused on serving their needs, and from the financial
3 stability of the post-merger company.

4 In fact, Frontier's shareholders, who are primarily professional financial
5 institutions with significant knowledge of the industry, recently voted
6 overwhelmingly to approve the transaction on October 27, 2009, indicating that
7 they believe the combined company will perform well and that value will be
8 generated by the combination of Frontier and the VSTO operations both in the
9 short term and over the longer term.[15] As such, a wide range of independent
10 professional constituencies are of the opinion that, not only is Frontier "fit" to
11 acquire the VSTO areas, but the combination will create a strong company for the
12 long-term benefit of all stakeholders.
13

14 **Q. What are the most appropriate considerations for determining that Frontier**
15 **is "fit" financially?**

16 A. The improved financial position of the combined company is based, first, on the
17 deleveraging and strengthening of post-transaction Frontier's balance sheet. The
18 deleveraging will assist the company in moving toward an investment grade
19 rating, which is expected to incrementally lower the company's capital costs.
20 Historically, ILEC transactions have often involved increasing, not reducing
21 leverage; so the deleveraging benefit of the proposed transaction is a notable and
22 intentional initiative on the part of Frontier, which Verizon fully supported.

[15] Exhibit No. __ DW-18, Frontier Communications Shareholders Approve Acquisition of Verizon Wireline Operations in 14 States, Press Release (October 27, 2009) (available at: http://phx.corporate-ir.net/phoenix.zhtml?c=66508&p=irol-newsArticle&ID=1346906&highlight). Yahoo Finance reports that 52% of the shares are held by approximately 335 financial institutions; see http://finance.yahoo.com/q/mh?s=FTR.

1 Second, Frontier will be able to generate relatively higher and more predictable
2 cash flows through the combined business in order to fund operations, required
3 investment, and payments to capital providers. Third, Frontier expects to have
4 better access to the capital markets and more cost-effective pricing for financial
5 resources in the wake of this transaction, in addition to being able to secure the
6 financing necessary to complete this transaction.
7
8 **1. Deleveraging the Balance Sheet**

9 **Q. How do you understand Mr. Weinman's concerns about Frontier's "cost**
10 **structure"?**

11 A. I believe that Mr. Weinman has raised various questions about Frontier's capital
12 costs today and in the future, and he is assuming that Washington customers will
13 be affected in terms of rates or possibly investment if Frontier's capital costs are
14 relatively more expensive than those of Verizon. My testimony will show that
15 Mr. Weinman's concerns are not warranted and certainly do not reflect
16 demonstrable harms. In addition, Mr. McCarthy explains that Mr. Weinman's
17 concerns regarding potentially higher rates as a result of a different cost structure
18 can be addressed by other means.
19
20 **Q. Several witnesses have testified that the combined company will have too**
21 **much debt.[16] Can you address their concerns?**

---

[16] *See*, e.g., Roycroft, p. 9, lines 13-16;p. 19, lines 10-12; p. 60, lines 11 ff.; Hill, p. 9, lines 34-44; p. 17, lines 9-11.

1 A. Yes, I can. One of the benefits of the proposed transaction is that it deleverages
2 Frontier and results in a post-merger company with a strong balance sheet. The
3 Joint Applicants agreed that the leverage ratio (net debt divided by Earnings
4 before Interest Expense, Taxes, Depreciation and Amortization or "EBITDA") to
5 be placed on the divested Verizon operations would be only 1.7 times the
6 EBITDA, using year-end 2008 financial data. I note that 1.7 times is below
7 Verizon's consolidated leverage ratio of 1.8 times EBITDA as of June 30, 2009;
8 but, on a proportionate basis, Verizon's net leverage ratio is 2.0 times.[17] The pro
9 forma Frontier, therefore, will have a conservative capitalization. Specifically,
10 Mr. McCarthy explained in his Direct Testimony that Frontier's leverage ratio is
11 estimated to decrease from a pre-transaction 3.8 times (based on year-end 2008
12 financial results)[18] to 2.6 times after the combination, before considering the
13 benefit of expected cost savings.[19] Including expected synergies, the 2008 pro
14 forma leverage ratio is estimated to improve further to approximately 2.2 times.[20]
15 I note that Staff witness Weinman reports that Verizon's debt-to-EBITDA ratio is
16 2.7 times, that Frontier's current leverage ratio is 4.6 times, and that the Frontier
17 ratio will decline to 3.0 times on a pro forma basis.[21] Those ratios are all

---

[17] Verizon's proportionate net debt-to-EBITDA ratio is actually 2.0x; the "proportionate basis" calculation adjusts for the fact that Verizon owns only 55% of Verizon Wireless, while reported consolidated financial statements reflect 100% of Verizon Wireless' results and balance sheet.

[18] Although the legacy Frontier leverage ratio has increased slightly to approximately 3.9 times as of June 30, 2009, that does not materially change the deleveraging effect of the proposed transaction.

[19] McCarthy Direct, p. 38.

[20] *Id.* The Frontier ratio excludes costs related to this transaction, which are one-time in nature and were not present in the 2008 pro forma combined company leverage ratios.

[21] Weinman, p. 23, lines 3-8.

1 incorrect. I am not clear how Staff calculated much higher ratios than the
2 numbers Verizon and Frontier have published. Frontier's pro forma leverage ratio
3 after synergies is expected to be close to that of Verizon and consistent with that
4 of an investment grade-rated telecom company. Again, the transaction is
5 expected to strengthen Frontier's balance sheet materially.
6
7 **Q. Please explain for the Commission how Frontier is deleveraging and**
8 **improving its credit profile if the company is adding significant debt?**
9 A. Although Frontier is adding just over $3.3 billion in net debt, the important fact is
10 that the company's capacity to service its debt improves to a proportionately
11 greater extent. Specifically, annual revenues, based on VSTO 2008 figures,
12 increase from $2.37 billion to over $6.5 billion, and EBITDA (revenues less cash
13 operating costs) correspondingly increases from $1.2 billion to over $3.1 billion,
14 *without* including any anticipated synergies.[22] With synergies, the combined
15 EBITDA increases to $3.6 billion, based on the 2008 results.[23] The effect is that
16 the company's leverage ratio falls, as I have already explained, because cash
17 flows rise to a proportionately greater degree than does debt.
18
19 **Q. Does Mr. Weinman's focus on additional or aggregate debt indicate a**
20 **significant risk?**

[22] Exhibit No. __ DW-19, New Frontier Presentation, p. 16.

[23] *Id.*

1 A. No. In the recent combination of CenturyTel and Embarq, which was approved
2 by this Commission, the transaction required the assumption of Embarq's debt of
3 $5.8 billion, which increased CenturyTel's net debt load to a total of over $8.8
4 billion.[24] I note that the increase in the acquirer's absolute level of debt actually
5 was greater in the CenturyLink transaction than in the proposed transaction. As a
6 result, the pro forma net leverage ratio for CenturyLink was expected to be 2.3
7 times before synergies (as CenturyTel's approximately 2.5 times pre-merger
8 leverage ratio was lowered by Embarq's around 2.2 times pre-merger leverage)
9 and 2.1 times after synergies,[25] levels very similar to Frontier's anticipated 2.6
10 times post-transaction net leverage, without including any synergies, and 2.2
11 times including synergies. Importantly, CenturyLink retained an investment
12 grade credit rating after the Embarq acquisition in spite of the fact that the net
13 debt load increased substantially. Further illustrating the insufficiency of
14 analyzing debt levels or the increase in debt alone, at the end of the second quarter
15 of 2009, AT&T had net debt of approximately $69.4 billion[26] and Verizon had
16 just over $64 billion[27] in net debt, after recently adding significant incremental
17 debt as a result of the Alltel acquisition. Yet, both companies remained solidly
18 investment grade.

[24] Exhibit No. __ DW-20, CenturyTel, Merger of CenturyTel and EMBARQ 8 (October 27, 2008), (hereafter "CenturyTel-Embarq Presentation"), p. 8 (available at http://www.centurytelembarqmerger.com/pdf/presentations/CenturyTel_EMBARQ_IR_Presentation.pdf).

[25] *Id.*

[26] AT&T, Strong Wireless Growth, Continued Cost Discipline, Solid Free Cash Flow Highlight AT&T's Second-Quarter Results, Investor Briefing 3 (July 23, 2009), (available at: http://www.att.com/Investor/Financial/Earning_Info/docs/2Q_09_IB_FINAL.pdf).

[27] Verizon, Q2 Investor Quarterly 2009 15 (July 27, 2009), (available at: http://investor.verizon.com/financial/quarterly/vz/2Q2009/2Q09Bulletin.pdf?t=633904300284080415).

1

2 **Q. Staff witness Weinman testifies that Frontier's relative improvement in**
3 **balance sheet strength is not relevant to Washington customers, as the**
4 **comparative leverage ratio for Frontier is higher than that of Verizon.[28]**
5 **How does Frontier's current leverage ratio and pro forma leverage ratio**
6 **compare specifically with those of other ILECs?**

7 A. Frontier's leverage ratio will not be as low as Verizon's (although Verizon's
8 proportionate leverage ratio of 2.0 times is not significantly better than Frontier's
9 expected ratio of 2.2 times including synergies), or, for that matter as low as
10 AT&T's. However, based on the calculation used frequently by industry
11 analysts—net debt to EBITDA—Frontier's leverage ratio compares favorably
12 with other major ILECs as is apparent in Table 1 that summarizes leverage ratios
13 for a group of comparable companies, and for the RBOCs, as of June 30, 2009.[29]

14

15 **Table 1: Net Debt to EBITDA, June 30, 2009**[30]

[28] Weinman, p. 11, line 16 through p. 12, line 4.

[29] I note that Verizon's ratio in the table is drawn from the company's reported financials, which are before the adjustment for the Vodafone share of Verizon Wireless; again, that adjustment makes the ratio 2.0 times.

[30] ALSK = Alaska Communications Systems Group Inc.; CNSL = Consolidated Communications Holdings Inc.; CTL = Centurytel, Inc.; HTCO = Hickory Tech Corp.; IWA = Iowa Telecommunications Services Inc.; OTT = Otelco Inc.; WIN = Windstream Corporation; FTR = Frontier Communications Corporation; Q = Qwest Communications International Inc.; T = AT&T, Inc.; VZ = Verizon Communications Inc.

(In $mils.)	ALSK	CNSL	CTL	HTCO	IWA	OTT	WIN	FTR	Pro forma FTR (2008) w/o syn.	Pro forma FTR (2008) w/ syn.	Q	T	VZ*
Total Debt	537	881	2,920	125	490	279	5,247	4,952			14,123	76,720	64,909
Less Cash	8	20	320	11	6	19	245	454			1,796	7,348	820
Net Debt	529	861	2,600	114	484	260	5,002	4,498			12,327	69,372	64,089
Trailing 12-mo. EBITDA	118	155	1,205	30	118	43	1,563	1,150			4,404	39,850	34,321
Net Debt/EBITDA	4.5x	5.5x	2.2x	3.9x	4.1x	6.0x	3.2x	3.9x	2.6x	2.2x	2.8x	1.7x	1.8x

1 *Verizon's net debt to EBITDA is 1.9x, but after adjusting for intercompany transactions with Alltel, the adjusted leverage ratio is 1.8x.

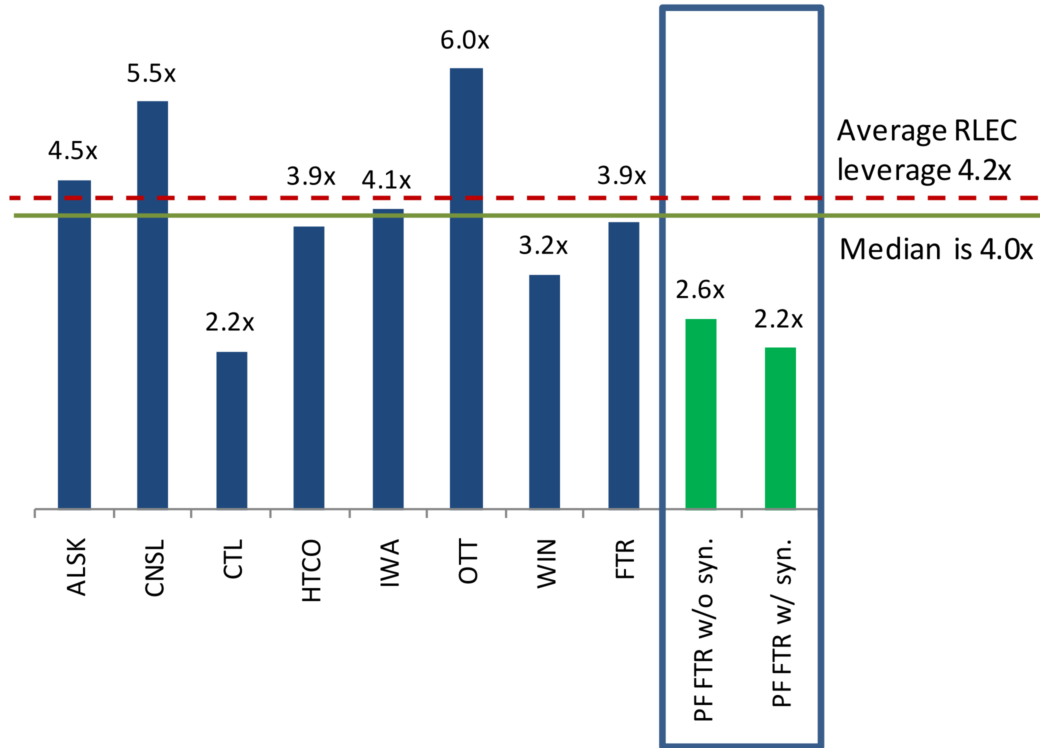
2 Source: Company SEC filings of 10-Qs for period ending June 30, 2009.

3

4 The table also highlights that the post-merger Frontier is expected to have an
5 exceptional leverage ratio compared with those of other rural local exchange
6 carriers ("RLECs") and compared with Qwest, which I believe are the appropriate
7 comparison group of companies.
8

1 **Figure 1: RLEC Leverage Ratios, June 30, 2009**

2



3
4
5 Source: Company SEC filings of 10-Qs for period ending June 30, 2009.

6

7 Post-transaction, Frontier will have relatively low leverage compared with the
8 ILEC group and is expected to be approaching an investment grade rating, with
9 management committed to a goal of achieving such a rating. I also note that
10 Frontier is expected to have exceptional levels of cash flows, compared with other
11 ILECs. Figure 1 illustrates the important point that even legacy Frontier has a
12 leverage ratio that is below both the average (4.2x) and median (4.0x) of this
13 group of companies, and I assert that, to the best of my knowledge, all those other
14 companies with higher leverage ratios are today providing reliable service to their
15 customers. Setting aside the legacy Frontier assessment, the leverage ratios of the

1 post-merger company (in the figure, the pro forma company is designated as "PF
2 FTR"), based on 2008 financials, put Frontier in a very strong position as the
3 second best carrier relative to the group, even before the realization of synergies.
4 With synergies, Frontier expects to have a leverage ratio that is in line with the
5 best ratio in the group of comparable companies. Thus, the proposed transaction
6 positions Frontier from a financial perspective to provide best-in-class service to
7 rural or lower-density communities, in addition to providing quality services to
8 higher-density communities with facilities obtained from Verizon to provide
9 advanced services. The data highlights that Frontier is not a highly-leveraged,
10 financially risky company, as the Staff has represented in its testimony, but rather,
11 an exceptionally strong carrier.
12
13 I note that Mr. Weinman makes two incorrect assumptions in his evaluations.
14 First, he assumes that the appropriate comparison for the pro forma combined
15 company to determine risk and/or harm is Verizon only.[31] I recommend that the
16 Commission take stock of the fact that every ILEC shown in Table 1, other than
17 AT&T, has a leverage ratio that is inferior to Verizon's. The universe of
18 comparison suggested by Mr. Weinman, therefore, is too small to determine what
19 is normative for this industry. The second assumption is more important. Mr.
20 Weinman assumes that a higher leverage ratio than that of Verizon actually "will
21 cause harm to Washington customers of Verizon NW" as he states in his
22 testimony.[32] This is where Staff has improperly equated "risks" with "harms."
23 Mr. Hill employs a similar argument, noting the Frontier's cost of capital will be

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[31] Weinman, pp. 5 ff.
[32] Weinman, p. 12, line 4.

1 higher than Verizon's.[33] I assert here that different leverage ratios or costs of
2 capital might be reflective of relative "risks" along some subjective continuum,
3 but they do not translate necessarily into harm. In fact, there will be no harm
4 because Frontier is committed to maintaining a rate cap that mirrors Verizon's
5 current rates, plans to invest more across the broader VSTO network than Verizon
6 has in the recent past, will have ready access to capital on competitive terms, and
7 is focused on maintaining service quality at levels that exceed customer and
8 regulatory expectations. If a higher leverage ratio is the same as harm, then it
9 might be argued with the same logic that Washington is harmed by Centurylink,
10 Qwest and other state providers of ILEC services whose ratios are inferior to
11 Verizon's. Again, a leverage ratio is not harmful unless the level of leverage
12 causes harms that directly affect customers, and there is no evidence that such
13 harms are likely or even quantifiable as a result of the proposed transaction. In
14 response to Mr. Weinman's Reasons 1 and 2,[34] differences in financial metrics
15 between Frontier and Verizon, in and of themselves, will not result in "harms".

16

17 **Q. Does a lower credit rating suggest a higher likelihood of default or a lesser**
18 **access to capital, which are "harms" that Mr. Weinman indicates are likely**
19 **to be "caused" by Frontier's lower credit rating?[35]**

20 A. No. Mr. Weiman again testifies about "*risks that are likely to cause harm* to the
21 Verizon NW Washington customers because Frontier has a lower debt rating than
22 Verizon."[36] [Emphasis added.] I assert that there is absolutely no evidence to

[33] Hill, p. 22, lines 19-20.

[34] Weinman, p. 5, lines 19-22.

[35] Weinman, p. 8, lines 15-21; King, p. 14, lines 21-22.

[36] Weinman, p. 8, lines 15-16.

1 support the likelihood of such harms or outcomes. First, credit ratings are
2 assigned to reflect overall risk in terms of corporate financial profiles and industry
3 forces. But a review of the industry comparables, as I just described above,
4 indicates that Frontier's leverage metrics generally are currently better than its
5 peer group and are expected to be much better than the group's metrics as a result
6 of this transaction. Standard & Poor provides an explanation of its ratings on its
7 website where it posts an informative document to clarify its ratings approach.
8 "Standard & Poor's credit ratings are designed primarily to provide relative
9 rankings among issuers and obligations of overall credit worthiness; *the ratings*
10 *are not measures of absolute default probability*."[37] [Emphasis added.] Thus the
11 ratings assess a company's relative status within an industry, but do not attempt to
12 quantify the probability of default. Frontier expects that its ratings and its credit
13 metrics will improve from very good relative comparisons at present to a level
14 that is near the best in the independent ILEC industry. Frontier will have access
15 to capital as it does today, and its credit rating is not indicative of the probability
16 of default as suggested in Mr. Weiman's testimony.
17
18 Second, I assert that the Commission's assessment of consumer-benefit should
19 not be solely or fundamentally driven by credit ratings, but by an assessment of
20 which carrier is likely to use its capital prudently and primarily to serve
21 Washington customers. I believe that the record is relatively clear that Verizon
22 intends to use its capital prudently and primarily to meet its growth initiatives but
23 not in lower-density service areas of VSTO like certain areas in Washington,

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[37] Standard & Poor's RatingsDirect, "Understanding Standard & Poor's Ratings Definitions", June 3, 2009, available at
http://www2.standardandpoors.com/spf/pdf/fixedincome/Understanding_Rating_Definitions.pdf.

1 while Frontier intends to direct its capital to serving precisely those relatively
2 lower density markets found in the VSTO areas. The relative credit ratings mean
3 little for the public interest if the companies in question are not dedicated to
4 devoting capital to serving the relevant customer base. I suggest that an analysis
5 of credit ratings or a comparison of Frontier to Verizon gives the Commission an
6 incorrect reading on the public interest, as Frontier will be exceptionally strong.
7 Moreover, Verizon's credit rating is in great part based on the fact that its
8 business and investment pattern is directed toward markets that are not lower-
9 density and have higher growth opportunities (e.g., wireless). So, I suggest that
10 the Commission's assessment should reflect that Verizon is not as likely to
11 provide the Washington-specific benefits that Frontier intends to offer.
12 Importantly, it should not be viewed as harmful to customers if a lower credit-
13 rated but still financially strong company chooses to invest levels of capital that
14 are expected to be higher on average than the investment of a company with
15 higher credit ratings. I cannot speak for Verizon, but I can assure the Commission
16 that Frontier intends to invest in the VSTO areas, including Washington. Among
17 the carriers that include lower-density markets in their strategic focus, post-
18 transaction Frontier will be exceptionally fit and strong financially, enabling the
19 company to provide service to customers in smaller and more rural communities
20 as confirmed by Figure 1.
21
22 **Q. Are investment grade bond ratings necessary for a company to maintain**
23 **access to capital?**
24 A. No. First, as I indicated previously, Frontier currently has ready access to capital
25 even though it does not have an investment grade rating. As I will discuss, we
26 recently had a very successful debt capital raise and we were offered more capital

1 than we felt prudent to take at the time. I also note that Moody's Investors
2 Service sponsored its "12th Annual Leveraged Finance Investor Briefing" in New
3 York City on October 29, 2009, at which the rating agency noted that only 37% of
4 the rated debt in the market was investment grade. Importantly, the statistics have
5 not changed significantly over the last five years, which means that companies
6 have access to capital in spite of a rating distribution that is significantly weighted
7 toward non-investment issues.[38]
8
9 Additionally, post-transaction Frontier expects to have credit statistics that are
10 improved and are close to investment grade. In fact, Frontier's management is
11 committed to the goal of achieving an investment grade rating for the combined
12 company. Today, there is only one major independent ILEC in the U.S. with an
13 investment grade rating—CenturyLink. All of the other major ILECs, including
14 pre-transaction Frontier and even Qwest, the largest telecommunications provider
15 in Washington, have credit ratings that are non-investment grade. However, these
16 non-investment grade carriers have ready access to capital, as illustrated recently
17 in the debt offerings from Frontier (discussed below) and Windstream,[39]. The
18 facts are clear that the ILEC industry is composed almost entirely of non-

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[38] Moody's Investor Service, "Moody's 12th Annual Leveraged Finance Investor Briefing," New York, New York, October 29, 2009, slide 10 of 135; according to Moody's the percentage of the total that was investment-grade-rated each year (January through December) from 2004 to the present was 38%, 36%, 35%, 35%, 35% and 37%, respectively. The 37% pertains to the first nine months of 2009.

[39] *See*, for example, Windstream Corporation, SEC Form 10-Q for the period ending September 30, 2009, available at http://www.sec.gov/Archives/edgar/data/1282266/000119312509229040/d10q.htm, p. 28, note 15; the note states that "[o]n October 8, 2009, Windstream completed the Private Placement of $400 million in aggregate principle amount of 7.875 percent senior unsecured notes due November 1, 2017. Proceeds from the Private Placement totaled $394.1 million, excluding debt issuance costs, with a yield of 8.125 percent. Windstream expects to use the net proceeds of the Private Placement to finance the cash portion of the purchase price of the D&E and Lexcom acquisitions, to refinance certain indebtedness of D&E in connection with the D&E merger, to pay related transaction fees and expenses and for general corporate purposes."

1 investment grade carriers that maintain access to capital without investment grade
2 ratings. To provide more detail, so far during 2009, more than 295 new non-
3 investment grade debt offerings totaling over $146 billion have been completed,
4 including 37 individual transactions over $1 billion in size.[40] The data
5 demonstrate that non-investment grade issuers, particularly those with relatively
6 stronger ratings, such as most ILECs including Frontier, have ready access to
7 capital. As a result, while Frontier believes it will achieve an investment grade
8 credit rating post-transaction, such a rating is not required to maintain access to
9 capital and Washington customers certainly will not suffer any meaningful harm
10 of Frontier's access to capital. Thus there is no evidence or likelihood of "harm"
11 that flows from Frontier's current or expected credit rating.
12
13 **Q. Should the Commission assume that an investment grade rating is necessary**
14 **for carriers serving Washington?**
15 A. No. The majority of ILEC services in the state of Washington are provided by
16 non-investment grade carriers. Table 2 highlights that Qwest, Washington's
17 largest ILEC service provider, does not have investment grade status for its
18 corporate/senior implied ratings, which is the appropriate comparison with
19 Frontier's corporate rating.[41] In fact, the table reveals that Qwest's credit ratings
20 are precisely in line with Frontier's current ratings (Mr. Weinman incorrectly

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[40] *See also* David R. Whitehouse, "Frontier-Verizon Spinco Financing," October 2009; attached as Exhibit No. __ DW-21.

[41] *See* Qwest Debt and Credit Ratings, as of September 30, 2009, available at http://investor.qwest.com/debt. The website lists four categories of credit ratings—Qwest Corporate Ratings/Senior Implied; Qwest Corporation International, Inc. ("QCII") (which is the name of the parent company); Qwest Corporation; and Qwest Capital Funding. Only Qwest Corporation has investment grade ratings according to S&P and Fitch, but Moody's does not rate Qwest Corporation as investment grade. Qwest's treasurer confirmed that Qwest Corporate Ratings/Senior Implied is the appropriate comparison of parent companies, as QCII has only selective debt placements.

1 reports Frontier's rating to be "B").[42] I note again that Frontier's rating may be
2 upgraded post-transaction as its credit metrics will improve, and, if an upgrade
3 were to occur, the company would have higher credit ratings than does the Qwest
4 parent company or for its senior implied ratings.
5
6 **Table 2: Frontier and Qwest Credit Ratings**

	Frontier Legacy	Qwest Corporate Rating/Sr. Implied
Standard & Poor's	BB	BB
Moody's Investors Service	Ba2	Ba2
Fitch Ratings	BB	BB

7
8
9 Source: Frontier 2009 S-4; Qwest Communications International Inc. available at
10 http://investor.qwest.com/debt.

11

12 Looking more closely at Qwest and Frontier in Table 3 below, Frontier's pre-
13 transaction balance sheet metrics and access line growth statistics compare
14 favorably with those of Qwest. As the table highlights, Qwest has higher relative
15 debt—long-term and total—as a percentage of total capitalization than does
16 Frontier today, and Qwest has been reporting more negative access line losses,
17 even as book shareholder's equity for Qwest was negative by more than one
18 billion dollars at the end of June 2009. So, while Frontier is not Verizon, the
19 company compares favorably with the largest carrier, Qwest, providing services
20 in Washington.
21

[42] Weinman, p. 8, lines 11-12.

1 **Table 3: Frontier and Qwest Balance Sheet and Access Line Growth**

($s in mils. for 2Q09)	Frontier Legacy	Qwest
Long term debt	4,945	13,038
Total debt	4,952	14,123
Shareholders' equity	448	-1,051
2Q09 access line growth	-6.5%	-10.7%
Net debt/EBITDA	3.9	2.8
Pro forma w/o Synergies	2.6	
Pro forma w/ Synergies	2.2	
LT debt/Capitalization	92%	109%
Total debt/Capitalization	92%	108%

2

3 Source: Frontier and Qwest 10-Qs for the period ending June 30, 2009.

4

5 **Q. Dr. Roycroft testifies that the VSTO properties currently have extremely low**
6 **leverage compared to Frontier's leverage, both standalone and pro forma**
7 **combined.[43] Is that assessment accurate?**

8 A. Not at all. Dr. Roycroft presents an incomplete picture. He reports the
9 approximate leverage of the VSTO operations alone and then compares it with
10 Frontier's leverage as a holding company. The calculation is incorrect and results
11 in a distorted perspective. The reality is that Verizon is a holding company, with
12 numerous subsidiary business units and operating companies, but Verizon no
13 longer chooses to finance through its telephone operating companies. This
14 corporate structure, used by many companies—including Frontier—allows the
15 holding company to issue debt, often at attractive terms, in addition to the debt
16 that might be issued at the operating company level. To be specific, as of June
17 30, 2009, Verizon's total debt outstanding ($64.9 billion) was composed of

[43] Roycroft, pp. 62-64.

1 approximately $21.9 billion of Verizon Wireless debt, $13.4 billion of wireline
2 operating company debt, and $29.6 billion of holding company debt (issued by
3 Verizon Communications Inc. or NYNEX).[44] Dr. Roycroft is not including the
4 Verizon holding company debt in his calculation, but is referring to the dedicated
5 VSTO operating company subsidiary debt alone.[45] In fact, if the Commission
6 were to look only at the debt at the VSTO operating company level, the VSTO
7 operating company debt levels will be unaffected by this transaction.[46] The
8 correct approach is to consider all of Verizon's debts (parent level), at the holding
9 company and subsidiary levels, to determine the leverage that will be supported
10 by the combined cash flows of the subsidiary operating companies. To be clear,
11 Dr. Roycroft is comparing "apples and oranges," that is, the *operating company*
12 *debt* of VSTO is being compared with the total debt—*holding company and*
13 *operating company*—of Frontier. As explained above, as of June 30, 2009,
14 Verizon's reported consolidated leverage ratio was 1.8 times[47] and its leverage
15 calculated on a proportionate basis was 2.0 times. So, while the VSTO operating

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[44] *See* http://investor.verizon.com/income/outstanding_debt.aspx.

[45] Exhibit No. __ DM-37, Transcript of Deposition of Trevor R. Roycroft, Ph.D., pp. 102-105.

[46] At this time the VSTO operating companies have debt obligations of $625 million. It is anticipated that $200 million in debt due February 15, 2010 will mature and be retired prior to the merger closing date. As a result, Frontier and Verizon anticipate that the indebtedness of the VSTO operating companies will be $425 million at closing. However, if the closing occurs after June 1, 2010, $175 million in debt will mature and be retired at that time, in which case the VSTO operating companies' debt at closing will be $250 million. The direct debt obligations of the VSTO operating companies will not change or increase as a result of the closing of the transaction. The debt associated with the $3.1 to $3.3 billion financing for the special payment to Verizon will be at the Frontier Communications Corporation parent company level and will not be direct debt for the VSTO operating companies. Accordingly, the leverage ratio of the VSTO operating companies will not change as a result of the transaction.

[47] Verizon, Q2 Investor Quarterly 2009 15 (July 27, 2009), available at http://investor.verizon.com/financial/quarterly/vz/2Q2009/2Q09Bulletin.pdf?t=633904300284080415.

1 companies may have lower leverage, they are part of the consolidated Verizon
2 and must contribute to servicing debt that is nearly two times the consolidated
3 EBITDA of Verizon. It is this leverage ratio that should be compared with
4 Frontier's consolidated holding company pro forma leverage ratios, which, based
5 on 2008 results, are 2.6 times before expected synergies and 2.2 times assuming
6 synergies are achieved. While there will be an increase in the debt that must be
7 supported by the VSTO operations, the increase is relatively small and is certainly
8 well short of the figures that have been calculated by Dr. Roycroft.
9
10 **Q. Have independent third-parties provided opinions on whether this**
11 **transaction is positive or negative from a credit perspective?**
12 A. Yes. The transaction will serve to strengthen Frontier's balance sheet in a
13 material way, and independent professional credit analysts have provided
14 confirmation. Moody's Investors Service highlighted that the proposed
15 transaction is actually beneficial when it put Frontier's credit ratings on review for
16 possible upgrade: "The transaction is expected to result in significant
17 deleveraging at Frontier, leading to a potentially improved credit profile."[48] Fitch
18 Ratings concurred in its press release, indicating that it was placing Frontier's
19 debt on Ratings Watch Positive, stating that, "The company to be merged into
20 Frontier will be moderately levered, and post-merger Frontier is expected to be

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[48]Exhibit No. __ DW-16. (Moody's Investors Service, Global Research Rating Action: Frontier Communications Corporation, May 13, 2009).

1 less levered than currently."[49] These positive ratings actions affirm the fact that
2 the proposed transaction was structured in a way that specifically serves to
3 enhance the balance sheet and credit quality of Frontier. In addition, Morgan
4 Stanley's senior telecommunications equity analyst wrote in a report dated August
5 14, 2009: "[T]he resulting entity should have investment grade-like credit
6 metrics."[50] Finally, Frontier has stated publicly that the proposed transaction
7 marks a shift in its perspective regarding the company's credit rating and its
8 intention to seek an investment grade credit rating. As noted above, CenturyLink
9 is the only major non-RBOC wireline telecommunications carrier with an
10 investment grade rating, and, as will be discussed in detail in Frontier witness
11 McCarthy's rebuttal testimony, Frontier's pro forma characteristics after the
12 transaction will very much resemble those of CenturyLink.
13
14 **Q. Can you address Staff's concerns regarding the level of dividend payments to**
15 **shareholders?**
16 A. Frontier, like other publicly-traded local telephone companies, must provide
17 competitive returns to its equity investors if the company is to maintain
18 reasonable access to capital. Staff is correct that Frontier assumes that it will be
19 paying its equity investors for the use of their capital. However, it is important to
20 understand that dividend payments are different from interest rate payments, as

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[49] Exhibit No. __ DW-17 (Fitch Ratings, Fitch Places Frontier Communications on Rating Watch Positive, May 13, 2009).

[50] Exhibit No. __ DW-22, "Frontier: Merger Integration on Track; Flow Back an Overhang," Morgan Stanley Research, August 14, 2009 (hereafter "Morgan Stanley August Report").

1 the compensation of equity-holders is discretionary. If Frontier finds itself unable
2 to generate cash flows necessary to meet all of its obligations, including necessary
3 capital expenditures, equity-holders' payments will be among the first uses of
4 cash flow that are at risk. That is the nature of equity risk, which shareholders
5 understand when they purchase equity securities, and that is the basis for their
6 expectation of returns that exceed more secure interest payments on debt. The
7 assumption that Frontier's customers will be put at risk before its equity-holders is
8 not correct, since the company understands that value of its equity will fall,
9 regardless of dividend payments, if the underlying business, which relies on its
10 customers, is not sound. Frontier cannot compensate shareholders and assume
11 that the stock price will be supported if doing so in any way puts at risk the core
12 business of providing high-quality communications services to our customers.
13
14 I note that the testimony of certain intervenors raises the question about dividends
15 and whether a particular dividend policy is in conflict with the underlying
16 business. Equity capital sources, like other sources of capital such as debt or
17 operating cash flows, are necessary to pay for operations and investment. All of
18 those sources have market-based costs, and the cost for equity in the ILEC
19 business is captured primarily in dividends. The intervenors suggestion that
20 payment of dividends somehow conflicts with the business interests of ILECs
21 does not reflect that business management, equity-holders, and debt-holders are
22 all working in concert to provide a long-term, viable business. Frontier must

1 properly address all of these capital sources to succeed in the competitive
2 marketplace.
3
4 **Q. Could you please respond to Mr. Weinman's Reason 6, where he asserts that**
5 **Frontier will be constrained from offering equity for two years from the close**
6 **date of the transaction?**[51]
7 A. Yes. First, Frontier is not required to rely on equity offerings to secure additional
8 capital on a going forward basis. To the extent necessary, Frontier could always
9 issue bonds or other debt instruments. With respect to the limited two-year equity
10 restriction, while I am not an expert on the requirements for maintaining the tax-
11 advantaged status of the transaction structure, it is my understanding that in
12 certain circumstances the company would still have the ability to raise additional
13 capital through an equity offering in the next two years. Generally, those
14 limitations would not restrict Frontier from issuing equity, over two years, if
15 Verizon's shareholders would still own more than 50% of the equity of Frontier
16 after the issuance. I have calculated Frontier's flexibility with respect to its equity
17 to be responsive to this question, and our understanding is that Frontier could
18 issue up to 274 million new shares during the period, which might mean $2.1
19 billion in new equity if the stock price were $7.75.[52] That provides Frontier with
20 a substantial cushion. Frontier believes that, given this ability to raise additional

[51] Weinman, p. 6, lines 4-5.

[52] The calculation assumes that Verizon shareholders would receive the fewest number (about 617.3 million shares) of Frontier shares (more shares would give Frontier even greater ability to raise equity), which would mean that Frontier could issue 274,974,505 additional shares and remain in compliance with the tax regulations associated with the Reverse Morris Trust.

1 capital if necessary through debt financing or limited equity offerings, Mr.
2 Weinman's reason 6 poses a virtually non-existent risk to consumers in
3 Washington.
4
5 **Q. Can you comment on Mr. Hill's calculation of Frontier's shares outstanding**
6 **post-merger?**[53]
7 A. Yes. Frontier will issue shares to Verizon shareholders, based on Frontier's 30-
8 day average share price at the time of closing, and the number of shares will be
9 established within a "collar" of $7.00 to $8.50. So the number of shares issued
10 will vary depending on the equity value of $5.247 billion divided by the 30-day
11 average price of the Frontier shares prior to close, assuming that price is within
12 the "collar" range. If the 30-day average price is above the "collar," then the
13 number of shares to be issued will be calculated using an $8.50 price per share; if
14 the 30-day average is below the "collar," then the number of shares to be issued
15 will be calculated using a $7.00 share price. Mr. Hill is confused, however, as he
16 is apparently stating that Frontier might have to issue more than 750 million
17 shares if the share price falls below $7 (although he states that Verizon
18 shareholders will only receive a maximum of 750 million shares, which is
19 correct).[54] While the confusion is somewhat ambiguous here, later Mr. Hill
20 asserts that if Frontier's stock price were to decline prior to the merger, the

[53] Hill, p. 13, lines 1-21.

[54] Hill, p. 13, lines 12-17.

1 projected dividend would exceed the combined company's cash flows.[55] Mr.
2 Hill's concern about the need to issue Frontier shares in excess of 750 million and
3 the resulting dividend obligations are unfounded, as there are clear protections
4 included in the merger agreement whereby Frontier will not have to issue more
5 than 750 million shares due to the "collar" mechanism. As such, Frontier's
6 dividend obligations are expected to continue to be a very manageable percentage
7 of the company's cash flows.
8
9 **Q. Can you comment on Mr. Hill's assessment of how Frontier's stock has**
10 **performed since the merger agreement was signed?**[56]
11 A. Yes. Mr. Weinman's Reason 5 also seems to be related to this issue.[57] Mr. Hill
12 notes that Frontier's stock price has underperformed the prices of the S&P500
13 Index and the NASDAQ Telecom Index in the period from April 1, 2009, which
14 was about a month and a half prior to the merger announcement, to September 14,
15 2009.[58] He asserts that "[t]his is an indication that investors are wary about the
16 merger and, relative to other investments, have assigned Frontier a lower
17 valuation as a result of the merger announcement."[59] However, at least with
18 respect to Frontier's share price, Mr. Hill is curiously selective regarding the dates
19 of his analysis. Mr. Hill notes that as of April 1, 2009, Frontier's stock price was

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[55] Hill, p. 46, lines 15-19.

[56] Hill, p. 14, line 1 through p. 15, line 5.

[57] Weinman, p. 6, lines 1-3.

[58] Hill, p. 14, lines 5-10 and p. 15, Figure 1.

[59] Hill, p. 14, lines 12-14.

1 $7.14 per share and "is currently below that level."[60] But, Mr. Hill, who filed
2 testimony on November 3, 2009, is for some reason basing his assessment on
3 Frontier's share price as of September 14, 2009. If Mr. Hill had updated his
4 analysis to the closing price as of market close on November 2, 2009, the day
5 before he filed testimony, he would have discovered that Frontier's share price
6 was $7.27, *above* the April 1st share price (but still predictably within the "collar"
7 share price range).
8
9 In addition to Mr. Hill incorrectly representing Frontier's share price as of the
10 time of his testimony, his interpretation of the relative price movements in the
11 market is wrong. Most fundamentally, the direct means of discerning investor
12 sentiment is to assess the vote on the proposed merger, and that vote was
13 overwhelmingly positive from institutions with significant capital at risk.[61] They
14 were not "wary" but very positive on the transaction.
15
16 **Q. What is the explanation for Mr. Hill's alleged "underperformance" of**
17 **Frontier's share price relative to the broader market and industry since the**
18 **transaction announcement?**
19 A. There are several explanations that are common for companies involved in
20 meaningful transactions, particularly transactions subject to a number of

[60] Hill, p. 14, lines 5-8.

[61] Exhibit No. __ DW-18, Frontier Communications Shareholders Approve Acquisition of Verizon Wireline Operations in 14 States, Press Release (October 27, 2009) (available at: http://phx.corporate-ir.net/phoenix.zhtml?c=66508&p=irol-newsArticle&ID=1346906&highlight).

1 regulatory approvals. First, investors are assessing opportunities to make money
2 in the short term and they recognize that the market as a whole presents other
3 opportunities in shares that do not have a valuation "collar" in place through the
4 second quarter of next year; so other investments attract more attention in such a
5 period. Second, there are uncertainties about whether and when the transaction
6 will close and what other developments might affect the valuation (if for example
7 another bidder appeared). Equity investors are reluctant to invest new money
8 when all of the near-term factors cannot be assessed with a greater degree of
9 certainty. Third, there is likely to be some temporary downward pressure on the
10 Frontier shares when the merger is completed as certain former Verizon
11 shareholders decide to sell because the investment thesis in Frontier is different
12 from the investment thesis they employed in making their original commitment to
13 Verizon shares (which notably are driven by wireless growth) or the shareholders
14 are required to sell based on the investment limitations of their specific fund
15 guidelines. There are a multitude of reasons for the shares "trading sideways"
16 while a transaction is pending, but the overwhelming shareholder approval
17 provides the most direct and compelling assessment of investor opinions
18 regarding whether or not the proposed transaction is a financially sound step for
19 Frontier—and the assessments reflected in the overwhelmingly positive
20 shareholder vote are strong evidence that contradict the judgment of Mr. Hill.

21
22 **2. Improved Cash Flows, Responsible Capital Allocation and**
23 **Prudent Dividends.**

24 **Q. You mentioned that Frontier will generate higher and more predictable cash**
25 **flows through the combination with the VSTO properties. Based on those**
26 **expected cash flow improvements, can you provide perspective regarding**

1 **Staff's and other intervenors' concerns about the relationship between book**
2 **net income/earnings per share and dividends?**[62]
3 A. Yes. Mr. Weinman raises this issue in his Reason 7.[63] First of all, dividends are
4 not measured solely, or even primarily, against net income or earnings per share,
5 nor should they be. The appropriate financial analysis, and the analysis required
6 by the financial markets, evaluates dividend payments in relation to free cash
7 flow. Book net income is an accounting calculation that contains numerous non-
8 cash entries, like depreciation, amortization, pension expense and income taxes
9 (which can be positive or negative in any given period). In addition, book net
10 income excludes capital expenditures, a major utilization of cash in the ILEC
11 business. Free cash flow, which is calculated after all cash outflows including
12 capital expenditures, better defines a company's ability to pay appropriate returns
13 to its shareholders while maintaining a sustainable business. *The Wall Street*
14 *Journal* makes this point as recently as the day of this filing, when it stated that
15 "[w]hile earnings are useful for tracking growth, or the lack of it, free cash flow
16 says more about the financial base from which future growth can occur . . . .
17 Investors are right to be impressed by a company with strong earnings growth, but
18 real cash is what's needed to pay dividends, reduce debt and help fund
19 expansion."[64] Staff witness Weinman appears to understand that the proper

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[62] Weinman, p. 9, lines 1-23; Hill p. 20, lines 15-23; Roycroft, pp. 55-60; King, pp. 13-14.

[63] Weinman, p. 6, line 7.

[64] Jack Hough, "Money to Spare," The Wall Street Journal, November 19, 2009; page D3: "Company earnings tend to tell a tidy story (if not always a happy one) from one period to the next, while changes in free cash flow can appear chaotic. Stock investors should look at both measures, especially now. While earnings are useful for tracking growth, or the lack of it, free cash flow says more about the financial base from which future growth can occur, particularly when credit is as tight as it is now. Earnings are an artificial vision of the money companies would make if sales and related costs always paired off neatly each quarter. In reality, the costs to make and market a widget are usually paid long before the proceeds from selling it are collected, and new widget factories are paid for with huge sums today, offset by decades of gradual sales. Free cash flow is simply the money a company collects minus what it pays in a given period. Investors are right to be impressed by a company with strong earnings growth, but real cash is

1 relationship to consider is the relationship between dividends and free cash flow,
2 not book net income or earnings per share, when he discusses the fact that
3 dividends are funded by free cash flows.[65] However, Mr. Weinman is using an
4 out-of-date percentage for dividends to free cash flow (60%-70% in his
5 testimony),[66] as the company has estimated the payout ratio in its publicly
6 available merger announcement materials at approximately 43% on a pro forma
7 basis, including synergies, and around 52% without the realization of synergies.[67]
8
9 **Q. Staff witness Weinman states that Frontier's dividend policy is "inconsistent**
10 **with a strategy of building additional broadband infrastructure, investing in**
11 **next generation operating support systems (OSS) and improving Frontier's**
12 **debt-to-EBITDA ratio . . ."[68], while Mr. King alleges that the company's**
13 **dividend policy is "unsustainable."[69] Are these correct assessments of**
14 **Frontier's policy?**
15 A. No, and I note that nowhere do either of the interveners support their assertions by
16 using industry statistics or Frontier financials. The post-transaction Frontier will
17 substantially increase its cash flows both *before and after* dividend payments. I
18 have included Table 4 below, which summarizes Frontier's historical free cash
19 flow generation, as well as pro forma free cash flow expectations for the new
20 Frontier. The table directly responds to the Staff's and Mr. King's testimony.
21 Free cash flow here is cash generated after funding all cash operating expenses to

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what's needed to pay dividends, reduce debt and help fund expansion."

[65] Weinman, p. 9, lines 3-4.
[66] Weinman, p. 9, lines 6-7.
[67] New Frontier Presentation, p. 16.
[68] Weinman, p. 9, lines 7-10.
[69] King, p. 14, lines 7-8.

1 run the business, cash taxes, cash interest expense on the company's debt, and all
2 capital expenditures, including the network investments that have expanded
3 Frontier's broadband service availability to over 92% of its current customer base
4 in its national service territory. Free cash flow does not include funds derived
5 from financing activities, such as loan proceeds or other borrowings.
6
7 **Table 4: Frontier Free Cash Flows—Historical and Pro Forma Combined**

($s in 000s)	2005	2006	2007	2008	4-yr. Total	2008 Pro Forma Pre-Syn	2008 Pro Forma Post-Syn
FCF Generation							
Free Cash Flow [1]	$ 527,971	$ 561,784	$ 528,005	$ 493,197	$ 2,110,957	$ 1,423,000	$ 1,733,000
Dividends Paid [2]	338,364	323,671	336,025	318,437	1,316,497	742,000	742,000
Payout Ratio	***64%***	***58%***	***64%***	***65%***	***62%***	***52%***	***43%***
Free Cash Flow after Dividends	**$ 189,607**	**$ 238,113**	**$ 191,980**	**$ 174,760**	**$ 794,460**	**$ 681,000**	**$ 991,000**

[1] Post-Synergies Pro Forma Free Cash Flow reflects the after-tax impact of $500 million in synergies and a 38% tax rate.
8 [2] Assuming Frontier issues shares at the mid-point of the collar.
9
10 Sources: Frontier 10-Ks 2006-2008; Exhibit No. __ DW-19, New Frontier Presentation.
11
12 Historically, from 2005 through 2008, Frontier generated free cash flows that
13 ranged from approximately $493 million to $562 million annually. Notably,
14 Frontier achieved these levels of free cash flow while simultaneously investing
15 over $1.1 billion cumulatively over the four-year period in its operations and
16 network, including broadband plant. The proposed transaction is expected to
17 *increase* Frontier's annual free cash flow, based on pro forma 2008 results, to
18 over $1.4 billion, without synergies, and over $1.7 billion after estimated
19 synergies are included. Importantly, the company's higher free cash flow post-
20 transaction will be used for capital investment *and* for supporting the company's
21 access to debt and equity financing. In recent years, as reflected in Table 4,
22 Frontier consistently generated free cash flow after dividends at annual levels
23 ranging from $175 million to $238 million. Post-transaction, even excluding

1 synergies, dividends will represent a significantly smaller percentage of Frontier's
2 free cash flow, with the result that Frontier in the post-transaction period will
3 generate meaningfully greater annual free cash flow after dividends—$681
4 million without synergies, and $991 million with synergies based on the 2008 pro
5 forma figures. Frontier's historical data demonstrate a financially sound business
6 approach that strikes a prudent balance among funding operations, investing in the
7 network, and providing required returns to capital providers—all while continuing
8 to generate sufficient amounts of cash flow to provide the board and management
9 with the financial flexibility to respond to market forces and opportunities.
10 Frontier has demonstrated its commitment to investment and to customers, and
11 competition will lead it to continue that strategic plan, assuming that the company
12 is not constrained by conditions that will limit Frontier's ability to respond to
13 market and technological changes. Finally, it is important to note that dividends
14 are discretionary payments, while interest and principal payments on debt are not.
15 Our equity investors know that Frontier will service its debt obligations first.
16
17 **Q. Mr. Weinman also expresses concern about whether or not "Frontier's cash**
18 **flow from Frontier would be able to fund its investment commitments**
19 **(including FiOS), operating expenses, interest payments on B rated debt [sic],**
20 **and dividends to common shareholders."[70] Does your testimony regarding**
21 **free cash generation address Mr. Weinman's concern and his Reason 8?[71]**
22 A. Yes, I believe that it does. It appears that Mr. Weinman is focused on
23 understanding whether or not the combined company will generate sufficient cash
24 flows to fund its operating and capital obligations. The pro forma data in Table 4

[70] Weinman, p. 16, lines 31-39.

[71] Weinman, p. 6, lines 7-9

1 above demonstrate unequivocally that Frontier will generate sufficient cash flows
2 to fund operating expenses, capital investment, interest payments and dividends.
3 In fact, after all cash obligations, the company expects to generate $680 million to
4 $990 million, depending on synergies achieved, in annual free cash flow that will
5 be available to further support Frontier's business including investment
6 commitments, operating expenses, interest payments and dividends.
7
8 **Q. Can you provide additional insights to aid the Commission in understanding**
9 **Frontier's philosophy regarding dividend payments and how they relate to**
10 **capital investment?**
11 A. Yes. Frontier seeks to maintain an appropriate balance for funding sources, and
12 to pay competitive market-determined rates. These sources of funds are important
13 as the company sustains its operations and funds capital investments. Equity
14 prices are determined by perceived market risks that drive returns to shareholders
15 achieved through growth in the business and dividend payments. This transaction
16 should allow the company to gain even better competitively-priced funding,
17 because the reduction in the pro forma company's leverage ratio, the increase in
18 the number of shares outstanding (liquidity), and the opportunity to generate
19 growth through realized efficiencies will make the company's debt and equity
20 more attractive. These factors also make it possible to reduce the dividend per
21 share by 25% at closing, as investors will focus on the potential for cash flow
22 growth, which combines with the dividend to create appropriate returns. Finally,
23 the reduction in the dividend results in more flexibility for the company, and
24 substantially reduces the proportion of free cash flow that goes to annual dividend
25 payments. This means that Frontier will have more cash, both in absolute-dollar
26 and percentage terms, to reinvest in its business or respond to competitive

1 opportunities. As the data presented in Table 4 above indicate, Frontier has a
2 history of making significant and ongoing investments in its network, as well as to
3 making prudent payments to financial stakeholders. The question is not one of
4 prioritizing dividends versus capital investment or capital investment versus
5 dividends, but rather of balancing the use of the company's cash flows and
6 investment resources, as Frontier has done, to reinvest in the business while
7 providing market-based returns to shareholders and preserving additional free
8 cash flow for discretionary uses.
9
10 **Q. Can you address the concerns of certain intervenor witnesses regarding**
11 **declines in Frontier's book equity account?**[72]
12 A. The concern that a company will not be financially sound if its book equity
13 balance varies over time is not well founded. For example, Qwest, as noted above
14 has a negative book equity account of more than $1 billion. Additionally, Embarq
15 had a negative equity balance for most of its corporate life after the operations
16 were spun-off from Sprint Corporation with the approval of this Commission, but
17 it had a substantial market capitalization as the financial community valued
18 operations, not on book equity, but on projected cash flows. Illustrating this fact,
19 as of March 31, 2009, Embarq reported more than $500 million in negative book
20 equity in its last independent quarterly filing with the SEC prior to the merger
21 with CenturyTel.[73] In addition, at the time of the merger Embarq had an
22 investment grade credit rating, indicating that the debt rating agencies were not
23 disturbed by the company's negative book equity. Further, other reliable

[72] Hill, p. 20, lines 21-23; King, pp. 13-14.

[73] Embarq Corporation, Form 10-Q (May 5, 2009) available at:
http://www.sec.gov/Archives/edgar/data/1350031/000119312509103531/d10q.htm.

1 communications companies have negative tangible book value, including
2 Comcast Corporation, parent of intervenor Comcast Phone of Washington, LLC
3 ("Comcast"). Comcast, as of the end of the second quarter of 2009, had a book
4 value of $40.450 billion but goodwill of $14.928 billion and intangible assets of
5 $63.743 billion, so that net tangible book value was a negative $37.253 billion.[74]
6 However, the financial markets perceive value above that negative balance and
7 evaluate Comcast on its cash flow generation. The public market value for
8 Comcast's equity, as of Tuesday, November 3, 2009, was $41.64 billion.[75] The
9 short answer is that the professionals in the financial markets value equity on the
10 basis of cash flows, not on book accounting entries.

11
12 **3. Access to Capital**

13 **Q. Staff witness Weinman is concerned about the terms associated with the**
14 **increased debt.[76] Can you address his concern?**
15 A. Yes. Mr. Weinman focuses in his testimony on the 9.5% interest rate included in
16 the merger agreement as the cap rate for the transaction financing. Above the cap
17 rate, Frontier will have the right to terminate the merger if it believes that the
18 actual interest rate and cash cost would unduly burden the combined company.
19 Mr. Weinman states that Staff discussed the potential interest rate on the
20 transaction financing with me and other Frontier personnel, and then he suggests
21 that "Frontier relies on optimistic management opinions without any definitive
22 data regarding the terms of the debt issuance."[77] Staff is suggesting that there are

[74] Comcast Corporation, Form 10-Q for the period ending June 30, 2009, available at: http://www.sec.gov/Archives/edgar/data/1166691/000119312509166759/d10q.htm.

[75] *See* Yahoo! Finance, available at: http://finance.yahoo.com/q?s=CMCSA.

[76] Roycroft, p. 62, lines 15 ff.; Weinman, p. 10, lines 1-25.

[77] Weinman, p. 10, lines 22-25.

1 unspecified and unverified "risks," based on its judgment that management's view
2 is optimistic. I will explain below that Frontier recently raised capital at rates
3 more favorable than 9.5%, even before the company is able to benefit from the
4 improved cash flows and better credit profile that will result from the transaction.
5
6 **Q. Staff witness Weinman notes that Frontier does not yet have specific terms**
7 **for financing the transaction,[78] and this concern forms the basis for his**
8 **reasons 9 and 10.[79] Can you address Frontier's ability to finance the**
9 **transaction on reasonable terms?**
10 A. Yes. Mr. Weinman is correct that Frontier will seek financing near the time of the
11 consummation of the transaction. This timing is due in part to the fact that
12 lenders will want to assess the risks arising from the regulatory processes, and
13 will want to assess the condition of the financial markets at that time. In terms of
14 understanding Frontier's ability to secure the financing on reasonable terms, the
15 most direct approach is to look to the financial markets to assess their current
16 opinion of the attractiveness of providing financing to Frontier. To my
17 knowledge, every institution important to this transaction has indicated its view
18 that the combination as structured will improve Frontier's access to capital. One
19 indicator of the financial markets' assessment of Frontier's creditworthiness came
20 on September 17, 2009, when Frontier was able to arrange new debt financing to
21 raise net proceeds of $577.6 million (gross proceeds of $600 million), through
22 8.125% (8.375% yield to maturity) Senior Notes due in 2018. Frontier announced
23 that the proceeds would be used, together with cash balances, to fund the
24 proposed repurchase ("Tender") of certain of its outstanding earlier-maturity

[78] Weinman, p. 10, lines 1-25.

[79] Weinman, p. 6, lines 10-14.

1 debt.[80] On October 1, 2009, Frontier announced the completion of the debt
2 offering.[81]
3
4 Furthermore, on October 16, 2009, Frontier announced that it had successfully
5 completed the Tender and had applied the full "Maximum Payment Amount" of
6 $700 million toward the repurchase of its outstanding 9.250% Senior Notes due
7 2011 (the "2011 Notes") and 6.250% Senior Notes due 2013 (the "2013
8 Notes").[82] As a result, Frontier's maturities through 2013 now consist of
9 approximately $7 million, maturing in 2010, $280 million maturing in 2011, $180
10 million maturing in 2012, and $746 million maturing in 2013. Therefore, Frontier
11 has reduced its aggregate principal amount of debt maturing in the one year
12 period following the closing of the proposed transaction (through 2011) to an
13 amount that could be refinanced primarily through surplus cash on hand or
14 through its existing $250 million undrawn credit facility, if necessary.[83]
15
16 The recent financing activities are significant for two additional reasons. First,
17 the successful debt offering in which Frontier was assigned effective rates of
18 8.375%, was executed on the basis of the company's *current* credit quality even
19 before the consummation of the Verizon transaction. With Frontier's improved

[80] Exhibit No. __ DW-23, Press Release, Frontier Communications Corporation Prices Offering of $600 Million of Its Senior Notes (September 17, 2009) (available at: http://phx.corporate-ir.net/phoenix.zhtml?c=66508&p=irol-newsArticle&ID=1333208).

[81] Exhibit No. __ DW-24, Press Release, Frontier Communications Corporations Announces Successful Completion of Notes Offering and Acceptance for Purchase of Certain 9.250% Senior Notes Due 2011 in Cash Tender Offer (October 1, 2009), (available at: http://phx.corporate-ir.net/phoenix.zhtml?c=66508&p=irol-newsArticle&ID=1337615).

[82] Exhibit No. __ DW-25, Press Release, Frontier Communications Corporation Announces Successful Completion of Debt Tender Offer (October 16, 2009) (available at: http://phx.corporate-ir.net/phoenix.zhtml?c=66508&p=irol-newsArticle&ID=1343034).

[83] *Id.*

1 credit and financial profile at the completion of the combination (discussed in
2 detail in my testimony), the rates and terms the combined company will attract at
3 the time of the transaction closing will likely be *at least as, if not more, favorable*
4 than the terms (rate of 8.375%) that Frontier achieved in its recent financing or
5 that it could attract at that time if the merger were not completed. Second, the
6 recent financing was completed at a rate well below 9.5%; and the merger
7 agreement provides a protective trigger if the transaction financing were for some
8 reason to require an annual interest rate above 9.5%, so Frontier does not have to
9 accept terms that would be unduly burdensome.[84] Therefore, information based
10 on actual debt issuance by Frontier in the market provides a reliable indication
11 that the company will be able to attract financing at interest rates that could be
12 lower than the most recent financing. That assessment is not "optimistic" nor is it
13 speculative, but is based on the real experience of Frontier within the last months
14 and the ongoing discussions with the company's investment advisors.
15
16 **Q. Why is it generally not prudent to obtain financing before the regulatory**
17 **approvals are determined?**
18 A. It is true that Frontier has not yet obtained commitments for the $3.3 billion in
19 debt that will be raised in connection with this transaction.[85] It generally would

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[84] Exhibit No. __ DW-26, Frontier Form 424B, Proxy/Prospectus (September 16, 2009) (hereafter "Frontier Proxy")
(available at: http://www.sec.gov/Archives/edgar/data/20520/000119312509194390/0001193125-09-194390-index.htm) at 90): ("Additionally, Frontier is not obligated to accept or execute documentation relating to the special cash payment financing or the Spinco debt securities if as a result thereof the weighted average annual cash interest rate (including annual accretion of original issue discount with respect to indebtedness issued with a material amount of original issue discount) payable on the aggregate of the special cash payment financing, the Spinco debt securities and any distribution date indebtedness would exceed 9.5%, unless Frontier reasonably determines in good faith that these coverage costs would not be unduly burdensome.").

[85] As noted above, Spinco will need to raise approximately $2.9 billion since there will be existing debt of $425 million that will remain in place at closing.

1 not be practical or cost-efficient to secure funding many months before the
2 consummation of the transaction. A commitment letter would be very costly,
3 creating unnecessary expense, and would contain a wide range of interest rates
4 which would not be capped, and hence would provide very little certainty as to
5 interest costs. Effectively, the high cost of a commitment letter would be harmful
6 to the company and its customers. Frontier's recent debt offering and tender offer
7 are positive market-based indications that make Frontier confident that the
8 required financing will be available on reasonable terms.
9
10 **Q. Are there other indications that the markets will be receptive to financing the**
11 **transaction at the time of consummation?**
12 A. Yes. The U.S. capital markets continue to improve on all major fronts as
13 volatility subsides, equity and corporate bond valuations improve, systemic risk
14 originating from the financial system has been greatly reduced, cash reserves held
15 by investors are beginning to be reinvested, and economic data indicate to
16 investors that there is "light at the end of the tunnel." Frontier's assessment is
17 that the transaction financing is likely to be attractive to investment-grade and
18 non-investment-grade investors. Thus, with the markets and economy showing
19 signs of improvement, and based on the response to recent financings, Frontier is
20 confident that there will be sufficient demand for the transaction financing to
21 allow the company to achieve very competitive rates and terms.
22

1 III. **FRONTIER'S PROJECTIONS ARE BASED ON REASONABLE**
2 **REVENUE EXPECTATIONS, COST MANAGEMENT AND CAPITAL**
3 **INVESTMENT.**

4 **Q. Can you respond to Mr. Weinman's Reason 3, which asserts that Verizon**
5 **has a broader product line which helps offset line losses?**[86]

6 A. Yes. Verizon is a diversified carrier with growth opportunities in businesses such
7 as wireless and enterprise services. While there is no disputing this fact,
8 Verizon's publicly-acknowledged strategic focus on non-ILEC businesses in
9 higher-density areas is apparently also the basis for Verizon assessing where it
10 needs to allocate capital and other resources. The company has made a decision,
11 based on its opportunities, that it wishes to allocate its capital in a way that it
12 judges will better meet the company's fiduciary duty to shareholders. Mr.
13 Weinman and Dr. Roycroft are simply stating the obvious about growth
14 businesses that are combined with more mature industries when they highlight
15 Verizon's growth businesses offsetting access line losses.[87] However, just
16 because a business—such as the VSTO business—is part of a broader set of
17 operations under a single corporate umbrella does not mean that it will have equal
18 access to the resources of the consolidated entity. Verizon's decision to divest the
19 VSTO areas is compelling evidence of Verizon's assessment of the relative
20 priority of the to-be-divested operations compared with its other businesses.
21 Frontier intends to commit relatively more capital and more management

[86] Weinman, p. 5, lines 23-24.

[87] *See*, for example, Roycroft p. 21, lines 8-17.

1 attention to serving the ILEC business in the VSTO areas, and we contend that
2 this focus will result in a net benefit to Washington customers.
3
4 **Q. Please comment on Mr. Hill's questions about whether the VSTO financial**
5 **data are accurate.**
6 A. Public Counsel witness Mr. Hill indicates that he is concerned with how the
7 "allocation of costs, capital, and revenues to a business that never existed on a
8 standalone basis [were] determined by Verizon management,"[88] and notes that the
9 VSTO operations have not been managed as distinct from other Verizon
10 operations.[89] He then suggests that Frontier has not examined sufficiently the
11 VSTO financial statements and is relying on the accurate reporting of Verizon
12 which will "benefit monetarily from making assumptions or allocations in that
13 process that lead to a higher valuation."[90] Finally, Mr. Hill raises his concern that
14 if the VSTO income statement has been overstated, the combined company
15 projections will be overly positive.[91]
16
17 There are several responses to Mr. Hill's unfounded and troublesome
18 speculations. First, Verizon's VSTO operations have verifiable revenue streams,
19 assets and personnel, which form a significant basis for understanding the
20 historical financial performance and future prospects of the business. Mr. Hill

[88] Hill, p. 4, lines 17-19.

[89] Hill, p. 21, line 3 though p. 29, line 2.

[90] Hill, p. 27, lines 2-9.

[91] Hill, p. 30, lines 1-6.

1 acknowledges that independent auditors audited the financial information he
2 refers to.[92] Second, there is legal recourse available if there has been a material
3 misrepresentation by Verizon regarding the financial performance of the VSTO
4 operations, as Verizon will have to attest to the accuracy of its representations as
5 part of the closing of the transaction (i.e., standard representations and warranties
6 will be required of both Frontier and Verizon as part of closing). Third, Verizon
7 is a company that has engaged in the process of transferring access lines and
8 business units numerous times before, and no such allegation has been raised
9 previously by Frontier in the transactions it completed with Verizon or its
10 predecessor or for that matter by any other acquiror, as far as I know. Fourth,
11 Frontier is an experienced operator and has had significant access to data provided
12 by Verizon, and those data can be tested for reasonableness. The short answer is
13 that it is unacceptable and inappropriate for Mr. Hill to make such allegations
14 without presenting any evidence to support his speculations. As such, the
15 Commission should give no weight to Mr. Hill's "concerns" about the accuracy of
16 the VSTO financial data upon which the transaction and related projections are
17 based.
18
19 **Q. Can you provide more detail on the synergies that Frontier expects to**
20 **realize?**
21 A. Yes. Mr. McCarthy will offer specific detailed testimony addressing the expected
22 synergies because he is the Chief Operating Officer of Frontier and will be tasked
23 with realizing operational efficiencies. However, from a financial point of view, I

[92] Hill, p. 29, lines 5-16. In fact the Report of Independent Auditors referenced by Mr. Hill was completed by Ernst & Young LLP, one of the largest and respected national public accounting firms.

1 assert that no synergies will be required to make this transaction financially sound
2 for the pro forma combined Frontier and its customers. Frontier is convinced that
3 its cost-savings and synergy estimates are realistic and achievable. However, if
4 one were to take the extreme approach of assuming that *no synergies* of any kind
5 are realized (an unrealistic assumption), the company still might be expected to
6 have a leverage ratio that is approximately in line with Windstream's ratio today
7 and a dividend payout ratio that is also consistent with that of Windstream.
8 Frontier is well positioned, with or without synergies, to realize key financial
9 metrics that will allow the company to be among the strongest in the non-RBOC
10 ILEC industry. The metrics will also make the company compare favorably with
11 Qwest as illustrated in Table 1 and Table 3 above. So, while I am confident
12 Frontier will achieve its synergy targets, or at the very least some of the annual
13 synergies disclosed to the public, the Commission should recognize that the
14 company will be a financially sound and strong operator regardless of whether
15 those synergies are generated.
16
17 **Q. What about Mr. Hill's suggestion that Frontier may have overpaid for the**
18 **VSTO operations?**[93]
19 A. Frontier is an experienced acquirer and operator of local telecommunications
20 properties. The company understands the likely revenues per subscriber, the costs
21 associated with maintaining plant, the models for expanding broadband, and the
22 costs of capital, among other key variables. The representation that Verizon is a
23 "savvy" dealmaker and that Frontier is "needy" is wrong and is based on

[93] Hill, p. 29, line 3 through p. 33, line 14.

1 speculation without any evidence.[94] Further, the suggestion that Frontier does not
2 understand the motivations, the limitations, and the strengths of the fairness
3 opinions delivered by its advisors is again wrong.[95] Frontier is an experienced
4 telecommunications services provider and can efficiently assess the revenue
5 streams, the access lines, the cost structure, the condition of plant, the relative
6 valuations of projected cash flows and the prices of comparable properties to
7 understand that this transaction makes sense. Consistent with much of his
8 testimony, Mr. Hill speculates without evidence. Frontier determined that the
9 relative consideration for VSTO is among the lowest of any RBOC transaction, in
10 spite of the fact that margins and revenues per line are high in this transaction
11 (meaning that Frontier believes that operating cash flows are high). There simply
12 is no credible evidence presented that Frontier was somehow duped by Verizon
13 into an inflated value of the VSTO areas.
14

15 **Q. Mr. Hill in his confidential testimony argues that Frontier's model is not**
16 **likely to be accurate in light of market conditions.[96] Can you comment?**

17 A. Yes. Without entering into debates about Mr. Hill's estimates, I note that Frontier
18 has confidence in its ability to understand revenue and expense opportunities in

---

[94] *See* Hill, p. 31, line 21 through p. 32, line 17.

[95] Mr. Hill states that, "[A]ll of the financial advisors have significant monetary incentive to provide an opinion that the transaction is 'fair' to stockholders." (Hill, p. 31, lines 13-14) As with his allegations regarding Verizon's financial data for the VSTO operations, Mr. Hill appears to believe that professional investment bankers from institutions such as Evercore, Citigroup, Barclays, and JP Morgan Chase would engage in deceit that would expose them to significant liability in order to receive compensation for a fairness opinion. It appears that Mr. Hill is willing to assail any institution's credibility and motives if it serves his purposes. However, once again, Mr. Hill engages solely in speculation and presents no evidence to contradict the analyses in the fairness opinions indicating that the value of the transaction is fair based on a wide variety of valuation methodologies.

[96] Hill p. 34, line 1 through p. 38, line, 19.

1 lower-density areas. To the best of my knowledge, Mr. Hill has no operating
2 experience and has not created financial models used in assessing and executing
3 ILEC transactions. By contrast, Frontier is a proven acquirer of local
4 telecommunications assets. The company has successfully acquired and
5 integrated properties over the last two decades and has had no major problems
6 with those acquisitions. Frontier's projections of revenues and expenses related to
7 the proposed transaction are grounded in that experience. Frontier consistently
8 has generated realistic projection models and has executed on those models with
9 superior results. The model provides a helpful and realistic tool. At the same
10 time, Frontier assumes that there will be changing economic and competitive
11 conditions. However, Frontier's management is confident in its understanding of
12 trends and the company's ability to integrate properties, as proven by its record
13 over the last two decades. Importantly, management also believes that Frontier is
14 a focused operator that can respond better to market conditions than can a
15 diversified communications entity that has many other pressing and potentially
16 distracting strategic obligations. If the industry forces were to be more negative
17 than anticipated, they will be negative for all major Washington telecom
18 companies—Frontier, Qwest, CenturyLink and others. I assert that it is better to
19 have a dedicated operator that includes lower-density markets in its focus if new
20 opportunities or challenges evolve. Frontier's proven focus on this strategic
21 communications industry segment makes it better prepared to respond quickly and
22 effectively to changes in the marketplace. Frontier is very comfortable that its
23 projections are reasonable and believes that the Commission should be skeptical
24 of speculative criticisms from intervening parties who provide no evidence and
25 have no experience operating telecommunications companies or executing ILEC
26 transactions.

1

2 In addition, as discussed above in my response regarding synergies, there is
3 sufficient "cushion" in Frontier's financial projections that the company's
4 operations could fail to meet expectations by an amount equivalent to the
5 estimated annual synergies ($500 million) and still remain a financially sound
6 operator. Frontier does not believe such a scenario is realistic, but the results
7 should provide the Commission comfort that the company has considered and
8 accounted for many of the issues raised by Mr. Hill. Mr. Hill goes on to offer his
9 views on several other matters including capital expenditures, which Mr.
10 McCarthy will address in greater detail in his rebuttal testimony.

11

12 IV. **RESPONSE TO PROPOSED CONDITIONS.**

13 **Q. Can you respond to Staff's proposed financial conditions?[97]**

14 A. Yes. Frontier believes that, because there is no likelihood of demonstrable harm
15 resulting from the proposed transaction, no conditions are required for
16 Commission approval. However, if the Commission determines that conditions
17 are necessary, those conditions should be imposed only to respond to clear and
18 definable *harms* that might reasonably result from this transaction. Speculative
19 *risks* should not be the basis for onerous and costly new obligations that exceed
20 the standard of protections already imposed on Verizon and other Washington
21 ILECs. Regarding the financial conditions proposed by Staff witness Weinman,
22 to achieve approval of the proposed transaction Frontier is willing to agree to
23 submitting quarterly reports regarding intercompany receivable and payables

[97] Weinman. p. 25, line 7 through p. 26, line 15.

1 accounts, including dividend payments. Frontier also will not object to filing a
2 petition for an Alternative Form of Regulation ("AFOR") within five years from
3 the close of the transaction. The company also agrees and has stated previously
4 that it will not seek to recover merger-related costs from Washington ratepayers.
5 Finally, the company is also willing to agree that it will submit a quarterly report
6 regarding synergy savings. In agreeing to Staff's recommended financial
7 conditions, Frontier believes that the Commission should have the information
8 and tools necessary to ensure that Washington customers benefit and are not
9 harmed as a result of the proposed transaction. As such, any additional financial
10 conditions proposed by other parties are extraneous and unnecessary, as I describe
11 in more detail below.
12

13 **Q. Can you comment on Mr. Hill's proposed condition that Verizon should be**
14 **compelled to reduce the consideration or make a monetary contribution in**
15 **order to ensure Frontier's financial strength?**[98]

16 A. Yes. Verizon will respond further, but Frontier emphasizes that Mr. Hill's
17 proposed condition is not appropriate since Frontier already has negotiated a fair
18 value for the VSTO areas, with Frontier and Verizon agreeing to a transaction
19 structure that results in a financially sound and strong operator. Additionally, Mr.
20 Hill does not quantify how he arrives at his proposed $600 million reduction in
21 the aggregate consideration, as he simply asserts that the consideration is too high.
22 Based on Washington's percentage of total VSTO access lines, Mr. Hill then

[98] Hill, p. 5, line 4 through p. 6, line 6; p. 50, lines 6-16.

1 calculates that $72.4 million of the proposed reduction dedicated to Washington,
2 clarifying that the reduction is exclusive of the $40 million escrow arrangement
3 proposed by Dr. Roycroft (I will address Dr. Roycroft's proposal below).
4 Frontier responds that Mr. Hill's proposal is unacceptable and inequitable. The
5 transaction agreement has been negotiated between two knowledgeable parties
6 with the benefit of the advice of sophisticated advisors, supported by financial
7 analysts and overwhelmingly approved by Frontier's shareholders. The
8 consideration is reasonable as compared to every other transaction of which I am
9 aware, and Mr. Hill offers no evidence to the contrary. There is no foundation for
10 a condition that dramatically changes the economic terms of a commercially
11 negotiated transaction. In any event, as indicated above, Frontier is willing to
12 accept Staff's proposed financial conditions, which should supersede and
13 eliminate the need for any financial proposals from other parties.
14

15 **Q. Mr. Hill also proposes that Frontier should be precluded from paying**
16 **dividends that are greater than its earnings, unless the company is able to**
17 **achieve an investment grade rating.[99] In addition, Mr. King suggests an**
18 **alternative dividend restriction be applied.[100] Can you comment on the**
19 **proposed conditions regarding dividend limitations?**

20 A. Yes. Frontier believes that such dividend limitation conditions are not acceptable
21 and, with respect to Mr. Hill's suggested restriction on parent company dividends,
22 is contrary to industry practice and the public interest. I explained above that
23 Frontier, like other independent ILECs, must raise equity at competitive prices.

[99] Hill, p. 52, lines 1-10.

[100] King, pp. 17-18.

1 The return on that equity is in part dependent on dividends, which are paid out of
2 cash flows, not book earnings, which are subject to various accounting
3 conventions. Equity-holders look for dividend payments because investors
4 rationally seek a reasonable return on their invested capital. A significant portion
5 of the value attributed by equity investors to dividends is based on the
6 predictability and sustainability of those dividends over time, so that the dividend
7 stream can be discounted back to current dollars as the investor attempts to
8 estimate the value of the security. Any condition that is likely to limit or put at
9 substantial risk the predictability and sustainability of the parent company
10 dividend might dramatically reduce the value of that dividend stream to investors,
11 causing a corresponding decline in Frontier's equity value. The net effect of a
12 limitation on dividends would be to impair severely the company's ability to
13 attract competitively priced equity capital. The result of this condition is entirely
14 predictable, which is to make Frontier's equity more costly (because the increased
15 risk to dividends will have to be factored into the security). The condition would
16 also mean that investors in telecommunications companies that serve rural and
17 suburban customers among others will re-direct their interest from Frontier's
18 stock to other securities. Any condition that threatens the viability of the dividend
19 stream which provides significant support to Frontier's equity value is likely to
20 affect the price for the company's equity, and hence could drive capital costs
21 higher.
22
23 **Q. What about the proposal of Dr. Roycroft that the Commission should require**
24 **that the Joint Applicants amend the Merger Agreement so that the §1.144**
25 **"Required Payment Amount" ("RPA") provision is removed for regulatory**

1 **costs imposed on Verizon by the regulatory approval process in**
2 **Washington?**[101]
3 A. Frontier objects to conditions that would require renegotiation of the transaction
4 agreements on the grounds that the risks in this transaction are not material, are
5 highly speculative, and cannot be compared with the risks that arose in certain
6 other telecommunications transactions that eventually failed due to newly
7 developed insufficient back office systems. Dr. Roycroft's proposed condition is
8 effectively a renegotiation of the terms of the Merger Agreement so that more
9 value can be extracted from Verizon, based on a regulatory mandate. As Frontier
10 witness Mr. McCarthy discusses in detail, this transaction is most comparable in
11 size and in financial ratios to the Century-Embarq transaction, which this
12 Commission recently approved. Frontier finds proposals for such conditions by
13 interveners to be intrusive, unprecedented and unacceptable. In addition, as I
14 explained above, the Frontier shareholders overwhelmingly approved this
15 transaction with Verizon on October 27th, and three states, South Carolina,
16 Nevada and California, have already issued orders approving and finding that this
17 transaction provides meaningful public benefits in its current form. Requiring a
18 renegotiation of the Merger Agreement, even if somehow feasible (which I do not
19 believe to be the case), would not be in the public interest. Frontier believes that
20 the terms of the transaction as-negotiated are entirely fair, and the effort to impose

[101] Roycroft Confidential, p. 93, lines 34 ff; Mr. Hill also recommends modifying the merger agreement so that his proposed conditions resulting in direct or indirect monetary contributions by Verizon will not result in additional equity issuance by Frontier. (Hill, p. 51, lines 1-4) Frontier objects to Mr. Hill's proposal for all of the reasons set forth in the response to Dr. Roycroft's similar proposed condition.

1 an additional economic harm or obligation on Verizon could jeopardize a
2 transaction that is demonstrably in the public interest.
3
4 **Q. Can you please comment on Mr. Weinman's assertion that increased**
5 **dividend payments would restrict cash available for other purposes such as**
6 **deploying broadband DSL services and other necessary capital**
7 **expenditures?**[102]
8 A. Mr. Weinman believes that the RPA provision in the merger agreement could
9 cause harm by weakening Frontier through the increased dividend requirement
10 resulting from additional share issuance and the possibility that there would be
11 less cash available for capital investment. As discussed above, the assumption
12 that Frontier's customers will be put at risk before its equity-holders is not correct,
13 since the company understands that the value of its equity will fall, regardless of
14 dividend payments, if the underlying business, which relies on its customers, is
15 not sound. Frontier cannot compensate shareholders and assume that the stock
16 price will be supported if doing so in any way puts at risk the core business of
17 providing high-quality communications services to our customers. Therefore, the
18 RPA need not be altered in order to protect investment funding.
19
20 **Q. Do you have comments regarding Dr. Roycroft's conditions that would**
21 **trigger the RPA?**[103]

[102] Weinman, p. 19, lines 11-13.

[103] Roycroft Confidential, p. 94, line 5 through p. 95, line 31.

1 A. Yes. Dr. Roycroft is proposing onerous conditions based on speculation
2 regarding potential harms for which he provides no evidentiary support. Dr.
3 Roycroft's proposed new conditions raise the costs of the transaction for Verizon
4 and Frontier. Dr. Roycroft is proposing a $40 million escrow fund to backstop
5 any required plant investment, and he is seeking potential penalties of $7.7
6 million annually to compensate Washington ratepayers if there is a failure in the
7 transition of Verizon's fully operational and proven back-office system.[104]
8 Frontier asserts that Dr. Roycroft's proposed conditions are vague and unfair, and
9 are not directed at addressing demonstrable harms but at the possibility that some
10 unquantifiable harm may occur in the future. "Need for remedial funds" or
11 evaluation of the systems are terms that invite dispute rather than create a sound
12 and enforceable agreement with certainty for all parties. Mr. McCarthy addresses
13 this point and in short, Frontier believes that changing of the terms of the RPA is
14 an unfair attempt to increase the financial burdens on Verizon, which again has
15 negotiated clearly defined and commercially-agreed-upon terms for a fair transfer
16 of the VSTO operations. Frontier also believes that the data archive, the escrow
17 fund, and the potential penalties are unnecessary and add costs to the transaction
18 that are not in the public interest.
19
20 **Q. Can you comment on Dr. Roycroft's proposal that $41 million in synergy-**
21 **savings should be "shared" through broadband deployment obligations in**

[104] Roycroft, p. 95, lines 7-23.

1 **Washington and Mr. Weinman's Reason 11?**[105]

2 A. Dr. Roycroft made similar proposals in other state proceedings, including
3 Washington,[106] when he reviewed the CenturyTel-Embarq transaction. He also
4 used the same methodology to estimate state-specific synergies, that is, taking
5 state access lines as a percentage of the total holding company access lines to
6 calculate a state synergy figure. No conditions based on Dr. Roycroft's proposals
7 were adopted by this Commission for the approval of the CenturyTel-Embarq
8 transaction, and none should be in this instance. My response to Dr. Roycroft is
9 that such a condition is unnecessary in Washington. Frontier is committed to
10 further improving its already financially-sound characteristics to benefit
11 customers through investment and services, to benefit employees through the
12 company's improved financial stability, and to gain better access to capital
13 through appropriate and lower-cost financing resources. Dr. Roycroft's proposal
14 undercuts the very rationale of this combination. Frontier requires increased
15 financial flexibility in operating during a turbulent competitive and economic
16 period. The synergies are intended to make the combined company stronger
17 financially and thereby to create a stronger inter-modal communications
18 competitor for Washington. By strengthening the company's competitive
19 platform, Frontier believes the combination will result in consumer-beneficial
20 market-based pricing (i.e., competition constrains prices) and more rapid

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[105] Roycroft, pp. 100-103; Weinman, p. 6, line 15.

[106] *In the Matter of the Joint Application of Embarq Corporation And Centurytel, Inc. For Approval of Transfer of Control of United Telephone Company of the Northwest d/b/a Embarq and Embarq Communications, Inc*. Docket No. UT-082119, Direct Testimony Of Trevor R. Roycroft, Ph.D. (TRR-1T), On Behalf Of Public Counsel (March 4, 2009), pp. 42-43.

1 introduction of enhanced service offerings in the marketplace. The benefits are
2 clear and affirmative. By contrast, Dr. Roycroft's condition eviscerates an
3 affirmative purpose of the transaction, which is to create a company with
4 improved financial flexibility to serve customers and other stakeholders.
5

6 Dr. Roycroft consistently has raised questions about Frontier's ability to respond
7 to investment demands and competitive pressures. Frontier agrees that those
8 external pressures are challenging for the industry, which is why this merger
9 represents an affirmative step forward in attempting to ensure that the merged
10 company is better able to flexibly respond. That is the motive for this stronger
11 telecommunications provider, and that is the clear benefit to consumers. We
12 contend that a stronger competitor is good for public policy and for all parties.
13 Frontier's view is that there is no benefit from such a sharing mechanism, and the
14 potential for harm in a rapidly changing competitive marketplace is meaningful.
15

16 Dr. Roycroft's proposed condition requiring synergy sharing to ensure broadband
17 investment is unnecessary.
18

19 **Q. Does this conclude your rebuttal testimony?**

20 A. Yes, it does.