

**Exhibit No. ___ HCT(RTA-1HCT)
Docket UT-100820
Witness: Rick T. Applegate
REDACTED VERSION**

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Joint Application of

DOCKET UT-100820

**QWEST COMMUNICATIONS
INTERNATIONAL INC. and
CENTURYTEL, INC.**

**for Approval of Indirect Transfer of
Control of Qwest Corporation, Qwest
Communications Company LLC, and
Qwest LD Corp.**

TESTIMONY OF

RICK T. APPLGATE

**STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION**

September 27, 2010

HIGHLY CONFIDENTIAL PER PROTECTIVE ORDER

TABLE OF CONTENTS

I. INTRODUCTION 1

II. SCOPE OF TESTIMONY 2

III. SUMMARY OF TESTIMONY 3

IV. DISCUSSION 3

 Transaction and Supporting Rationale 3

 Risks Associated With the Financial Aspects of the Transaction 5

Integration Costs 8

Synergies 10

Assumption of Substantial Debt 12

Line Losses and Declining Revenue 17

Litigation and Ring Fencing 22

Other Considerations 25

 Recommended Financial Conditions for Approval of the Transaction..... 25

V. CONCLUSION 27

EXHIBIT LIST

Exhibit No. ____ (RTA-2)	S-4 Pro Forma Combined Condensed Financials
Exhibit No. ____ (RTA-3HC)	Consolidation Model
Exhibit No. ____ (RTA-4)	S-4 Risk Factors
Exhibit No. ____ (RTA-5HC)	Synergies, Attachment to CenturyLink's Response to UTC Staff Data Request No. 16
Exhibit No. ____ (RTA-6HC)	Debt Maturities, Attachment to CenturyLink's Response to UTC Staff Data Request No. 27.5
Exhibit No. ____ (RTA-7)	Fitch Ratings, Attachment CenturyLink's Response to UTC Staff Data Request No. 27.1
Exhibit No. ____ (RTA-8)	Moody's Ratings, Attachment to CenturyLink's Response to UTC Staff Data Request No. 27.3
Exhibit No. ____ (RTA-9)	Standard & Poor's Ratings, CenturyLink's Response to UTC Staff Data Request No. 27.2
Exhibit No. ____ (RTA-10HC)	Implication of Loss of Investment Grade Rating
Exhibit No. ____ (RTA-11HC)	CenturyLink Revenue Forecast
Exhibit No. ____ (RTA-12HC)	Cash Flow Analysis
Exhibit No. ____ (RTA-13C)	CenturyLink ILECs' 2009 Annual Report
Exhibit No. ____ (RTA-14C)	Qwest's 2009 Annual Report

1 I. INTRODUCTION

2
3 **Q. Please state your name and business address.**

4 A. My name is Rick Applegate. My business address is the Richard Hemstad Building,
5 1300 S. Evergreen Park Drive SW, P.O. Box 47250, Olympia, WA 98504. My e-
6 mail address is rapplega@utc.wa.gov.

7
8 **Q. By whom are you employed and in what capacity?**

9 A. I am employed by the Washington Utilities and Transportation Commission
10 (“Commission”) as a Regulatory Analyst in the Regulatory Services Division.

11
12 **Q. How long have you been employed by the Commission?**

13 A. I have been employed with the Commission since August 2008.

14
15 **Q. Please state your educational and professional background.**

16 A. I graduated from the University of Montana in 2001 receiving a degree in Business
17 Administration with an emphasis in Finance. In 2005, I received a J.D. from the
18 Willamette University College of Law and an M.B.A. from the Atkinson Graduate
19 School of Management.

20 My current responsibilities include the analysis of general rate cases and
21 other filings of energy companies. I also have analyzed interconnection agreements,
22 affiliated interest transactions, contracts, and other commercial filings of
23 telecommunications companies. I filed responsive testimony in the Verizon/Frontier

1 merger proceeding, Docket UT-090842,¹ and the Embarq Access Charge Complaint,
2 Docket UT-081393.² I have also participated as a Staff analyst in the
3 Embarq/CenturyTel merger proceeding, Docket UT-082119,³ and presented at public
4 open meetings.

5 Prior to joining the Commission, I worked for various employers in the legal,
6 real estate, and financial services industries.

8 II. SCOPE OF TESTIMONY

9
10 **Q. What is the purpose of your testimony?**

11 A. I comment on the financial aspects of the proposed merger of CenturyLink, Inc.
12 (“CenturyLink”) and Qwest Corporation International, Inc. (“QCII”) to support the
13 testimony of Staff witness Mark Vasconi.

14
15 **Q. Have you prepared exhibits in support of your testimony?**

16 A. Yes. My narrative testimony is presented as Exhibit No. ___ (RTA-1HCT). In my
17 testimony, I reference Exhibit No. ___ (RTA-2) through Exhibit No. ___ (RTA-12C).

18

¹ Docket UT-090842, *Joint Application of Verizon Communications Inc. and Frontier Communications Corporation for an Order Declining to Assert Jurisdiction Over, or, in the Alternative, Approving the Indirect Transfer of Control of Verizon Northwest Inc.*

² Docket UT-081393, Formal complaint from Verizon Select Services, Inc.; MCIMetro Access Transmission Services, LLC; MCI Communications Services, Inc.; Teleconnect Long Distance Services and Systems Co., d/b/a Telecom USA; and TTI National, Inc. vs. United Telephone Company of the Northwest to reduce intrastate switched access charges.

³ Docket UT-082119, *Joint Application of Embarq Corporation (“Embarq”) and CenturyTel, Inc., for Approval of Transfer of Control of United Telephone Company of the Northwest d/b/a Embarq and Embarq Communications, Inc.*

1 CenturyLink subsidiary. Following this merger, QCII will survive as an immediate
2 subsidiary of CenturyLink and the CenturyLink subsidiary will cease to exist. In
3 exchange for their interest in QCII, QCII stockholders will receive 0.1664 shares of
4 CenturyLink for each QCII share forfeited. In total, QCII shareholders will own
5 approximately 49.5 percent of the merged company, and CenturyLink shareholders
6 will retain the remaining 50.5 percent. While the transaction will not result in the
7 issuance of incremental debt, CenturyLink will assume \$11.5 billion in QCII debt
8 bringing its total debt balance to approximately \$19.5 billion. In Exhibit No. ____
9 (RTA-2), I present the Pro Forma Combined Condensed Financials for the
10 Combined Company that were part of CenturyLink's S-4 filing ("S-4") with the
11 Securities and Exchange Commission ("SEC").

12
13 **Q. Apart from the changes to CenturyLink and QCII described above, will this**
14 **transaction affect the CenturyLink or QCII corporate structures or change how**
15 **the companies are regulated in the state of Washington?**

16 A. With the exception described above, the transaction essentially will leave the
17 existing corporate structure of CenturyLink and QCII intact.⁴ CenturyLink provides
18 services in Washington as an incumbent local exchange carrier ("ILEC") through
19 four subsidiaries, CenturyTel of Washington, Inc., CenturyTel of Inter-Island, Inc.,
20 CenturyTel of Cowiche, Inc., and United Telephone Company of the Northwest
21 (collectively the "CenturyLink ILECs"). QCII offers telecommunications services in
22 Washington through three subsidiaries. For the purposes of my testimony, I will

⁴ Docket UT-100820, Direct Testimony of John Jones, Exhibit No. __ (JJ-1T), at p. 5.

1 only discuss one, Qwest Corporation (“Qwest”). The Combined Company will
2 preserve CenturyLink ILECs and Qwest as separate operating entities. Accordingly,
3 this transaction should not affect the manner in which the Commission regulates
4 CenturyLink ILECs or Qwest.⁵

5
6 **Q. Please summarize the rationale for the proposed transaction.**

7 A. This transaction will merge two of the nation’s largest telecommunications
8 providers. The Combined Company should benefit from economies of scale.

9
10 **Risks Associated with the Financial Aspects of the Transaction**

11
12 **Q. Why are you testifying about risks associated with the financial aspects of this
13 transaction?**

14 A. A deterioration of the financial condition of the Combined Company could harm the
15 public.

16
17 **Q. How would you identify a deteriorated financial condition?**

18 A. In evaluating the financial condition of the Combined Company, I focus primarily on
19 three metrics, earnings before interest taxes depreciation and amortization
20 (“EBITDA”), long-term debt, and free cash flow after dividends. I use EBITDA as a
21 measurement of the Combined Company’s capacity to meet its financial obligations,

⁵ *Id.* at p. 5.

1 make capital expenditures, and pay dividends. I use long-term debt to gauge the
2 company's future interest payments, a major nondiscretionary use of EBITDA.
3 Accordingly, the amount of money the Combined Company will have to invest
4 capital and pay interest, taxes, and dividends will decline as long-term debt increases
5 relative to EBITDA. Finally, I use projected cash flow after dividends to measure
6 the capacity of the Combined Company to reduce long-term debt. I also view it as a
7 margin for error in financial forecasts. According to CenturyLink's financial
8 consolidation model ("Consolidation Model" Exhibit No. ___ RTA-3HC),
9 CenturyLink anticipates the following values for these metrics:

10 **Table 1: EBITDA, Debt, and Cash Flows⁶**

11
12
13 **REDACTED**
14
15
16
17

18 **Q. What harms could result from a Combined Company with a deteriorated**
19 **financial condition?**

20 **A.** A deterioration of the financial condition of the Combined Company could result in
21 the following public interest harms:

⁶ Exhibit No. ___ (RTA-3HC).

- 1 1. The company might have to reduce dividend payments depriving its investors of
2 a fair rate of return on their investment. The company could delay or reduce
3 capital investment in new technologies or services that would improve customer
4 offerings such as internet protocol television (“IPTV”) or broadband internet
5 upgrades and deployment.
- 6 2. The company may not be able to meaningfully compete with other
7 communications companies including cable providers offering integrated voice,
8 data, and television (“TV”) services.
- 9 3. The company may defer or avoid maintenance of infrastructure resulting in
10 degraded service.

11

12 **Q. Has CenturyLink made disclosures about the financial risks of this transaction?**

13 A. Yes. As part of the S-4, CenturyLink prepared a section called “risk factors.” It
14 appears as Exhibit No. ___ (RTA-4). In this section, CenturyLink provides a
15 discussion of the most significant factors that make this specific transaction
16 speculative or risky.⁷ Even though this section has an intended audience of securities
17 regulators and the broader investment community, this Commission should consider
18 the risks it discloses.

19

20 **Q. Are there any risk factors in the S-4 which you believe this Commission should**
21 **pay particular attention?**

⁷ 17 C.F.R. 229.503, SEC Instructions for Filing Forms Under Securities Act of 1933, Securities Exchange Act of 1934 and Energy Policy and Conservation Act of 1975—Regulation S-K, Prospectus summary, risk factors, and ratio of earnings to fixed charges.

1 A. Yes. I believe five risk factors in particular present potential public interest harm in
2 Washington. Later in my testimony, I discuss each in detail. For now, I simply
3 present these factors as the following:

- 4 • CenturyLink is expected to incur substantial expenses related to the integration of
5 QCII.
- 6 • Following the merger, the Combined Company may be unable to integrate
7 successfully the business of CenturyLink and QCII and realize the anticipated
8 benefits of the merger.
- 9 • In connection with the merger, CenturyLink will assume a substantial amount of
10 indebtedness and may need to incur more in the future.
- 11 • If CenturyLink and QCII continue to experience access line losses similar to the
12 past several years, following the merger the Combined Company's revenues
13 earnings, and cash flows may be adversely impacted.
- 14 • Any adverse outcome of the KPNQwest litigation or other material litigation of
15 QCII or CenturyLink could have a material adverse impact on the financial
16 condition and operating results of CenturyLink following the merger.

17
18 ***Integration Costs***

19
20 **Q. Will the combined entity incur integration costs as a result of the merger?**

21 A. Yes. The companies anticipate the expenditure of \$800 million to \$1 billion in
22 integration costs. According to the Consolidation Model, the Combined Company
23 anticipates these expenditures to occur in the following years:

1 **Table 2: Integration Costs⁸**

2
3
4 **REDACTED**

5
6
7
8 **Q. Why does the expenditure of approximately \$800 million to \$1 billion constitute**
9 **a potential harm?**

10 A. The \$800 million to \$1 billion is a direct result of the transaction and would not
11 result if the companies remained separate. Accordingly, public harm will result from
12 this transaction if the combined entity passes these costs on to customers.

13 My analysis indicates that integration costs should not cause the financial
14 condition of the Combined Company to deteriorate. [REDACTED]

15 [REDACTED]

16 [REDACTED]

17 [REDACTED]

18
19 **Q. Do you recommend any conditions that mitigate the risk of harm from**
20 **integration costs?**

21 A. Yes. I recommend that the Commission prohibit the Combined Company from
22 seeking recovery of integration costs from ratepayers in regulated rates. This

⁸ Exhibit No. ___ (RTA-3HC).

1 provision is consistent with the Commission's most recent order in the merger
2 between Verizon and Frontier in Docket UT-090842. I describe this condition
3 further at the conclusion of my testimony.

4
5 *Synergies*

6
7 **Q. Please describe the synergy savings expected to result from the merger.**

8 A. CenturyLink anticipates that the merger will result in annual operating cost synergies
9 of \$575 million and capital expenditure synergies of \$50 million within three to five
10 years of closing.⁹ Exhibit No. ____ (RTA-5HC) presents a detailed breakdown of
11 synergy sources.

12 A failure to achieve synergies probably would not result in a degraded
13 financial condition, especially in the near term. The following table from the
14 Consolidation Model (Exhibit No. ____ RTA-3HC) shows forecasted cash flows
15 related to synergies.

⁹ Docket UT-100820, Testimony of Clay Bailey, Exhibit No. ____ (GCB-1T), at p. 11.

Table 3: Synergy Cash Flows¹⁰

REDACTED

[REDACTED]

[REDACTED]

Q. Do you recommend any conditions related to synergies that would prevent against risk of harm?

A. Yes. I recommend that the Commission require regular reporting of achieved synergies to ensure that rates remain fair, just, and reasonable following the merger. This provision is consistent with the Commission's most recent order in the merger

¹⁰ Exhibit No. ___ (RTA-3HC).

1 between Verizon/Frontier, Docket UT-090842. I will describe this condition further
2 at the conclusion of my testimony.

3
4 **Q. Do you have any basis beyond the S-4 risk factors to question the synergies**
5 **savings projected by CenturyLink?**

6 A. No. The combination of CenturyLink and QCII undoubtedly presents opportunities
7 to eliminate redundant functions or to achieve economies of scale. My analysis has
8 not indicated any major flaws or weaknesses in CenturyLink's estimated synergy
9 values.

10
11 *Assumption of Substantial Debt*

12
13 **Q. How much debt will QCII add to CenturyLink and what repayment obligations**
14 **will this create?**

15 A. QCII will contribute \$11.5 billion in long-term debt to the Combined Company,
16 bringing total debt to approximately \$19.5 billion.¹¹ Exhibit No. ___ (RTA-6HC)
17 presents the debt maturities that will confront the Combined Company. [REDACTED]

18 [REDACTED]

19 [REDACTED]

20 [REDACTED]

21 [REDACTED].¹² Fitch, Moody's, and Standard & Poor's ratings of CenturyLink

¹¹ Exhibit No. ___ (RTA-2).

¹² Exhibit No. ___ (RTA-4HC).

1 and QCII debt provide probably the best insight into the Combined Company's
2 ability to repay this debt on a long-term basis.

3
4 **Q. How do Fitch, Moody's and Standard & Poor's rate debt issued by**
5 **CenturyLink and QCII?**

6 A. Ratings from Fitch range from 'AAA' (highest) to 'C' (typically the lowest),
7 depending on alphabetical order and on the number of letters assigned. So, for
8 example, an 'AA' rating is superior to an 'A' rating, which would in turn be better
9 than a 'BBB' rating. Ratings may also be modified by the addition of a plus (+) or
10 minus (-) sign to show relative standing within the major categories. 'BBB-'
11 represents the lowest investment grade rating.¹³

12 Many institutional investors will only hold the debt of companies that receive
13 an investment grade rating. As a result, companies with subinvestment grade ratings
14 typically incur higher effective interest rates, or higher capital costs, than companies
15 with investment grade status when issuing new debt.

16 Ratings from Moody's range from 'Aaa' (highest) to 'C' (lowest) depending
17 on the first letter's alphabetical order and the number of 'a's appearing after the first
18 letter. So, for example, an 'Aa' rating would be superior to an 'A' rating which
19 would in turn be better than a 'Baa' rating. Moody's may also append a 1, 2, or 3 to

¹³ For more information about Fitch credit ratings and definitions see:
http://www.fitchratings.com/creditdesk/public/ratings_definitions/index.cfm.

1 each rating to denote standing within a ratings category. 'Baa3' represents the lowest
2 investment grade rating.¹⁴

3 Ratings from Standard & Poor's range from 'AAA' (highest) to 'D' (lowest).
4 Like Fitch, ratings may be modified by the addition of a plus (+) or minus (-) sign to
5 show relative standing within the major rating categories. 'BBB-' represents the
6 lowest investment grade rating.¹⁵

7 The following table presents ratings for long-term unsecured debt issued by
8 four of CenturyLink and QCII's issuing entities:

9 **Table 4: Credit Ratings**

10

	Fitch	Moody's	Standard & Poors
CenturyLink	BBB-	Baa3	BBB-
Embarq	BBB-	Baa3	BBB-
Qwest	BBB-	Ba1 - Baa1	BBB-
QCII	BB	B2 - Ba3	BB

11
12
13
14
15
16

17 **Q. What has Fitch said about the Combined Company's long-term debt?**

18 A. Following the announcement of the merger, Fitch Ratings placed the issuer debt
19 ratings ("IDRs") of CenturyLink on Rating Watch Negative.¹⁶ This means that Fitch
20 could downgrade CenturyLink debt from 'BBB' to 'BB' following completion of the

¹⁴ A full discussion of Moody's ratings definitions and methodologies is available at:
<http://v3.moodys.com/ratings-process/Ratings-Definitions/002002>.

¹⁵ For more information about Standard & Poor's credit ratings and definitions see:
<http://www.standardandpoors.com/ratings/definitions-and-faqs/en/us>.

¹⁶ Exhibit No. ____ (RTA-7).

1 merger. However, Fitch appears to reserve judgment on the downgrade until after
2 more becomes known about the Combined Company including its actual integration
3 costs, synergies, and overall financial performance.

4 The agency also placed the IDRs of QCII on Rating Watch Positive
5 suggesting that it may increase QCII's IDR from 'BB' to 'BBB' following the
6 merger. Qwest will probably retain a 'BBB-' rating from Fitch for its senior
7 unsecured debt following the transaction.

8
9 **Q. What has Moody's said about the Combined Company's long-term debt?**

10 A. Following the announcement of the transaction, Moody's changed its rating outlook
11 to negative. The ratings outlook reflects the execution risk of the acquisition, the
12 secular decline in the wireline industry, and the possibility that the Combined
13 Company may fail to achieve synergies. In its announcement, Moody's said:

14 Moody's could downgrade CenturyTel's long-term rating if the
15 Company's operating performance deteriorates, or if Qwest's
16 operating performance falls short of expectations and its EBITDA
17 continues to decline, such that the merged entity is unable to sustain
18 financial leverage (Total debt-to-EBITDA, Moody's adjusted) of less
19 than 3.0x and if free cash flow generation falls into the low single
20 digit percent of debt.¹⁷

21
22 **Q. What has Standard & Poor's said about the Combined Company's long-term
23 debt?**

24 A. Standard & Poor's has said "the pro forma leverage is probably not supportive of an
25 investment grade rating credit profile, despite prospects for potential deleveraging
26 given the integration challenges and continuing access-line losses across the

1 industry.”¹⁸ Standard & Poor’s goes on to say, “[w]e currently expect that if the
2 transaction is completed as planned, the corporate credit rating is likely to be ‘BB+’
3 or ‘BB’.”
4

5 **Q. What are the likely effects of a lower credit rating on the company’s cost of**
6 **debt?**

7 A.

[REDACTED]

8 [REDACTED]

9 [REDACTED]

10 [REDACTED]

11 [REDACTED]

12 [REDACTED]

13 [REDACTED]¹⁹

14

15 **Q. Could a ratings downgrade result in public interest harm?**

16 A. Yes. Debt costs along with equity cost make up a company’s cost of capital, which
17 represents a key component in the determination of regulated rates. If the Combined
18 Company’s ILECs pass a higher cost of debt or equity through to their customers in
19 the form of higher rates, then a ratings downgrade could negatively affect customers.

20 Higher costs of debt could also increase the Combined Company’s overall
21 capital costs, which could result in diminished capital investment in items that
22 maintain or improve service offerings. When considering major capital spending

¹⁸ Exhibit No. ___ (RTA-9).

¹⁹ Exhibit No. ___ (RTA-10HC).

1 projects, companies undertake an analysis to verify that the present value of future
2 money received from the project exceeds the present value of costs incurred in the
3 project. To determine a present value, the company will discount future cash flows
4 using the company's cost of capital, an average of the company's debt and equity
5 costs. Higher cost of capital translates into a lower present value. Accordingly, a
6 higher cost of debt for the Combined Company may deter the company from
7 pursuing projects that are at or near a net present value of zero.

8
9 **Q. Do you recommend any conditions to prevent against risk of harm?**

10 A. Yes. I recommend that the Commission prohibit the Combined Company from
11 seeking recovery of noninvestment grade rated debt and equity costs. This provision
12 is consistent with the Commission's recent order in the merger between Verizon and
13 Frontier, in Docket UT-090842. I will describe these conditions further at the
14 conclusion of my testimony.

15
16 ***Line Losses and Declining Revenues***

17
18 **Q. Please describe the recent history of the decline in access lines and revenue of
19 CenturyLink and QCII respectively?**

20 A. The following table reflects the decline in these metrics from 2007 to 2009:
21
22
23

Table 5: Access Lines and Revenues²⁰

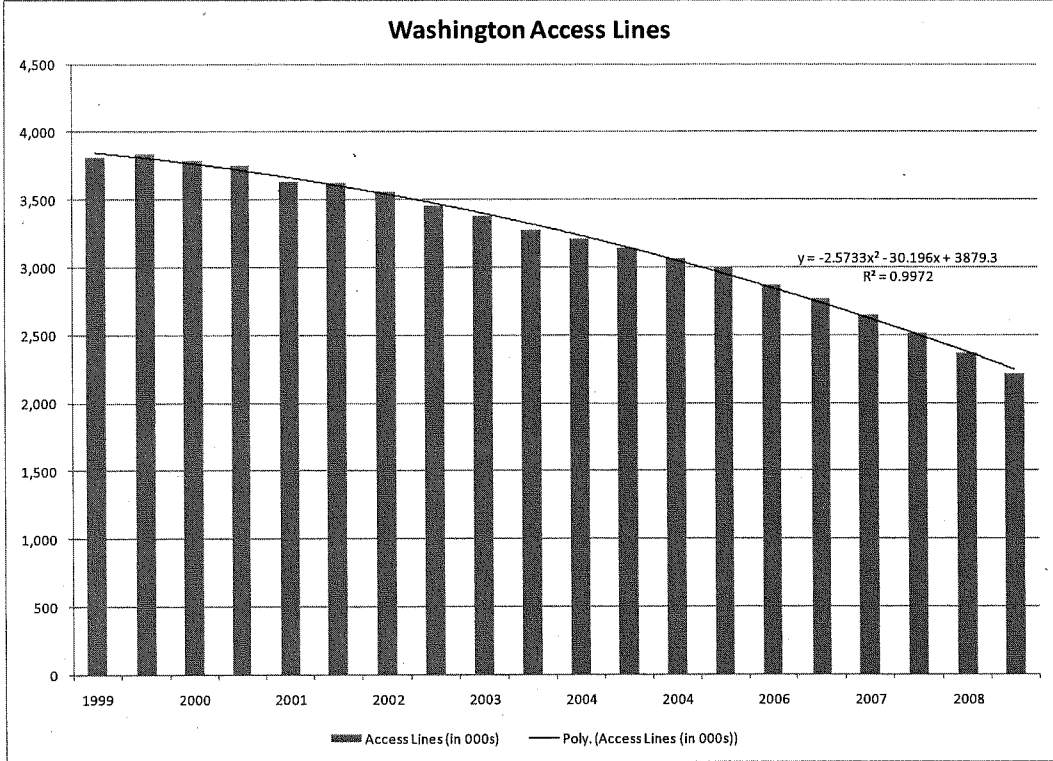
#s in thousands, \$s in millions	2009	2008	2007	2008-2009 % Change	2007-2008 % Change	
CenturyLink /CenturyTel	Access Lines	7,039	7,725	8,435	-8.88%	-8.42%
	Broadband	2,259	2,083	1,923	8.45%	8.32%
	Revenue	\$ 7,645	\$ 8,723	\$ 9,021	-12.36%	-3.30%
QCII	Access Lines	10,266	11,565	12,789	-11.23%	-9.57%
	Broadband	2,974	2,847	2,611	4.46%	9.04%
	Revenue	\$12,311	\$13,475	\$13,778	-8.64%	-2.20%
Total	Access Lines	17,305	19,290	21,224	-10.29%	-9.11%
	Broadband	5,233	4,930	4,534	6.15%	8.73%
	Revenue	\$19,956	\$22,198	\$22,799	-10.10%	-2.64%

Q. Are declining access lines and revenues a consistent result across the telecommunications industry or does it reflect poorly on CenturyLink and QCII?

A. Declining customer counts and revenues do not reflect poorly on either CenturyLink or QCII. ILECs across the industry have experienced declines as the result of customers substituting wireless and voice over internet protocol (“VoIP”) communications for wireline services. Figure 1 below shows this decline accelerating in Washington since 1999.

²⁰ CenturyLink and Qwest 2009 Form 10-K; Embarq 2008 Form 10-K. 2009 CenturyLink revenues equals the sum of CenturyTel 2009 annual revenue reported in Form 10-K (\$4,974,239,000) and Embarq Form 8-K reporting unaudited June 30, 2009 Year-to-Date Revenue (\$2,671,000,000).

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24



tion. Based on

Q. What changes in revenue does CenturyLink anticipate?

A. In Exhibit No. ___ (RTA-11HC), which contains forecasting of CenturyLink revenue, Page 1 shows detailed projections of revenue for CenturyLink (excluding QCII) from 2010 through 2013. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17

[REDACTED]

[REDACTED]

[REDACTED]

Q. Do declining revenues present a risk of harm?

A. Yes. Declining revenues threaten the ability of a company to deliver services because they diminish the company’s ability to pay the costs of furnishing those services. Revenue represents a major component of EBITDA, a key metric in the determination of a company’s credit rating. Declining revenue can also lead to goodwill impairment, which would result in non-cash losses and reduced balance sheet assets.²¹ With respect to the Combined Company, a goodwill impairment write off will reduce the Combined Company’s equity and, depending on the magnitude of the write off, could affect the company’s debt-to-equity ratio.

Q. Do CenturyLink’s revenue projections show these risks?

A. [REDACTED]

[REDACTED]

²¹ As the result of this transaction, CenturyLink goodwill is estimated to increase by \$10.252 billion to \$20,681 billion or approximately 39.5 percent of total assets. The Statement of Financial Accounting Standards (FAS) No. 141 defines goodwill in part as the “excess of the cost of an acquired entity over the net amounts assigned to assets acquired and liabilities assumed.” It is an intangible asset not subject to amortization or depreciation like other tangible assets. Rather, companies test for impairment annually by comparing the fair value of these assets with the recorded amounts (FAS No. 142). If the recorded value exceeds the assets’ fair market value then an impairment or asset write down will be necessary. The company will then incur an expense reducing the corresponding goodwill amount. CenturyLink tests the goodwill of its regional business units by comparing revenues of the regional business unit with the business unit’s recorded asset value.

²² The Consolidation Model shows the Combined Company’s debt to EBITDA ratio of 2.5 decreasing to 2.3 from 2010 to 2013. Over the same period, Moody’s expects the Moody’s adjusted EBITDA ratio to range between 2.8 and 3.0 and has identified a ratio of 3.0 as a point where a ratings decline might occur. See Exhibit No. ___ (RTA-8).

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21

[REDACTED]

Q. Do you have any concerns with CenturyLink's revenue projections?

A. [REDACTED]

2. [REDACTED]

²³ [REDACTED]

²⁴ Exhibit No. ___ (RTA-3HC).

²⁵ *Id.*

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23

[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

[REDACTED] My calculations appear in Exhibit No. ___ (RTA-12HC) and are supported by the annual report filings of CenturyLink ILECs, Exhibit No. ___ (RTA-13C), and Qwest, Exhibit No. ___ (RTA-14C).

Q. Do you recommend any conditions related to access lines and revenues that would prevent against risk of harm?

A. Yes. I recommend that the Commission require a special financial report that provides a snapshot of company EBITDA, debt, and share price at the time of the merger. Such a report would be helpful with the financial oversight of the Combined Company. It is also consistent with the Commission’s most recent order in the merger between Verizon and Frontier, in Docket UT-090842. I will describe this condition further at the conclusion of my testimony.

Litigation and Ring Fencing

Q. Please describe the KPNQwest litigation.

A. According to QCII’s most recent SEC Form 10-Q filing, QCII and other parties, including former chief executive officer Joseph P. Nacchio, are defendants in various proceedings seeking billions of dollars in aggregate damages related to the failure of

1 a telecommunications carrier, KPNQwest. KPNQwest was apparently a
2 telecommunications company equally owned by the Dutch national telecom operator
3 KPN and QCII that collapsed in 2002.²⁶ While the litigation is potentially material
4 to the financial health of the Combined Company, the magnitude of its impact is
5 neither known nor measurable.
6

7 **Q. Why do you include the KPNQwest litigation in your testimony?**

8 A. I include the KPNQwest litigation to illustrate how this merger will expose an even
9 greater portion of Washington telecommunications services to what would be
10 isolated nonsystematic risks of a single company.
11

12 **Q. Is there a regulatory mechanism that can mitigate the spread of risk between**
13 **affiliated companies?**

14 A. Ring fencing is a term used to describe certain restrictions intended to insulate a
15 regulated utility from legal or financial misfortunes that might befall its affiliates. In
16 theory, ring fencing enables a utility to continue normal business operations as a
17 standalone company even though a parent or affiliate experience financial distress or
18 bankruptcy. Typical aspects of ring fencing include certain limitations on payments
19 to affiliates including dividends to parent entities, restrictions on ILEC debt, and
20 mandates to invest capital. This Commission has generally required the companies
21 to accept “ring fence” provisions before receiving approval of a merger or
22 divestiture. Precedential cases include Scottish Power’s acquisition of PacifiCorp,

²⁶ Wikipedia <http://en.wikipedia.org/wiki/KPNQwest>.

1 Bell Atlantic's acquisition of GTE, Sprint's divestiture of United and, recently, Puget
2 Holdings, LLC's acquisition of Puget Sound Energy.

3
4 **Q. Do you recommend any ring fencing conditions to prevent against risk of harm?**

5 A. Implementation of ring fencing in the telecommunications industry presents
6 significant challenges because of the high level of interdependence among ILECs
7 and their affiliates, including parent companies.²⁷ Cash flow restrictions between
8 affiliates, which represent central features of ring fencing, become prohibitive to
9 these interdependent operations. Staff has previously expressed reservations about
10 the effectiveness of ring fencing safeguards in telecommunications merger cases and
11 I share many of these concerns.²⁸ Accordingly, I recommend that this Commission
12 limit its use of ring fencing provisions to financial reporting conditions that identify
13 intercompany payables and receivables as well as enhance the Commission's
14 affiliated interest reporting rules. However, I also recommend that the Commission
15 prohibit the Combined Company from encumbering any of the assets of the
16 regulated ILECs. This is consistent with the Commission's recent order in the
17 merger between Verizon and Frontier, in Docket UT-090842. I will describe these
18 conditions further at the conclusion of my testimony.

19

²⁷ For an extended discussion of services provided to regulated CenturyLink entities in Washington, see Docket UT-091974, CenturyLink Affiliated Interest Service Agreement.

²⁸ See Docket UT-090842, *Joint Application of Verizon Communications Inc. and Frontier Communications Corporation for an Order Declining to Assert Jurisdiction Over, or, in the Alternative, Approving the Indirect Transfer of Control of Verizon Northwest Inc.*, Direct Testimony of Bill Weinman at pp. 17-18.

1 ***Other Considerations***

2
3 **Q. Could a material change in the transaction change your analysis?**

4 A. Yes. A material change to the transaction could alter my conclusions. I propose that
5 CenturyLink and QCII be required to notify this Commission of any such change
6 prior to the transaction closing.

7
8 **Q. In preparing your analysis did you rely on Washington specific information that**
9 **is currently reported by CenturyLink ILECs and Qwest?**

10 A. Yes. Washington specific information currently reported by CenturyLink ILECs and
11 Qwest played a valuable role in my analysis. I propose that Washington specific
12 information currently provided by CenturyLink ILECs and Qwest under Commission
13 rule or order continue following completion of the transaction.

14
15 **Recommended Financial Conditions for Approval of the Transaction**

16
17 **Q. What financial conditions do you recommend?**

18 A. I recommend that this Commission approve this merger subject to the following
19 conditions:

- 20 1. For a period of five years following the date the transaction closes, CenturyLink,
21 the parent, and its Washington local exchange carriers, CenturyTel of
22 Washington, Inc., CenturyTel of Cowiche, Inc., CenturyTel of Inter-Island, Inc.,
23 and United Telephone Company of the Northwest (collectively the “CenturyLink
24 ILECs”), and Qwest Communications International, Inc. (QCII) local exchange
25 carrier operations in Washington, Qwest Corporation (Qwest), must submit
26 quarterly reports to the Commission listing for each entity the account balances
27 of intercompany receivables and payables, including the beginning balance of

1 each, the change for the quarter and the ending balance. This report must also
2 show for each quarter the dividend that CenturyLink declares to be paid to its
3 shareholders (in total and per share).
4

5 2. The analysis of cost of capital for the purposes of any results of operations must
6 be based upon "investment grade" debt and equity. CenturyLink currently
7 enjoys an investment grade debt rating and Washington customers should not be
8 required to bear higher capital costs due to lower ratings as a result of this
9 transaction.
10

11 3. CenturyLink must report to the Commission synergy savings resulting from the
12 proposed transaction for each six-month period as well as year-to-date. The
13 synergy savings report must include the accounts receiving synergies benefits by
14 company for CenturyLink ILECs and Qwest. The first report shall be filed six
15 months after the transaction closes and should identify the method CenturyLink
16 ILECs and Qwest used to calculate the synergies. Any subsequent methodology
17 change to the synergy calculation will be identified and reported by CenturyLink
18 explaining the change and its effect on the previous calculations. This report will
19 be completed every 6 months after the date the transaction closes until all the
20 synergies from this transaction have been realized, and shall contain the
21 following information:
22

- 23 a. Costs and projected savings associated with each respective activity on a
24 CenturyLink total company basis;
- 25
- 26 b. Consolidation and organizational changes to network operations and staffing
27 levels in the Washington operations of CenturyLink ILECs and Qwest;
- 28
- 29 c. Impacts on Washington operations and customers.
30

31 4. CenturyLink ILECs and Qwest must hold retail and wholesale customers
32 harmless for increases in overall management costs that result from the
33 transaction.
34

35 5. CenturyLink ILECs and Qwest will not seek to recover from Washington
36 wholesale and retail customers any separation, branding and transition costs.
37 These costs will be borne by the CenturyLink stockholders. The types of costs in
38 this category include, but are not limited to, transaction costs (accounting,
39 banker, legal advisor, investment banker, and other fees), OSS conversion costs,
40 severance costs (including "golden parachute" payments), new employee
41 employment costs, executive bonuses for work associated with the transaction,
42 and the costs of developing and establishing the brand name. CenturyLink will
43 record these costs in separate subaccounts on the parent and the operating
44 company's accounting records. These costs shall be reported annually, on the
45 anniversary date of the closing of the transaction, as long as the company is
46 incurring integration costs.
47

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28
29
30
31
32
33
34
35
36
37

- 6. CenturyLink may not encumber the Washington assets of CenturyLink ILECs or Qwest.
- 7. Within 30 days after the day the transaction closes, CenturyLink must notify Staff of the CenturyLink post-transaction consolidated Net Debt/EBITDA and the price per share used to determine transaction shares and the calculation of the share price.
- 8. For all affiliated interest transaction filings under WAC 480-120-375, CenturyLink ILECs and Qwest must:
 - a. Certify in the cover letter for the filing that the transaction complies with 47 C.F.R. 32.27 (“Transactions with affiliates”);
 - b. Determine that the cost of the transaction is reasonable and consistent with the public interest and, upon request of Staff, CenturyLink, a CenturyLink ILEC, or Qwest, provide cost support documentation prior to the effective date of the transaction.
- 9. The Joint Applicants must immediately notify the Commission of any material change to the transaction terms and conditions set forth in their application that: (1) occurs while a Commission order on the merits of the transaction is pending, or (2) occurs before the transaction closes but after the Commission issues its order on the merits of the transaction. The Joint Applicants also must submit a supplemental application for an amended Commission order in this docket if there is any change in substantive transaction conditions and terms that affect Commission-regulated services in Washington.
- 10. After the transaction closes, CenturyLink ILECs must maintain their books to ensure they will continue to report Washington operations to the Commission consistent with the Washington-specific data that is being reported currently by CenturyLink ILECs and Qwest.

V. CONCLUSION

Q. In summary, have you tested CenturyLink’s projections for Combined Company cash flows?

A. Yes.

1 **Q. In your analysis, have you applied more conservative cash flow assumptions**
2 **than CenturyLink?**

3 A. Yes.

4

5 **Q. With your more conservative analysis and the financial conditions you**
6 **recommend, do you believe the financial aspects of this transaction meet the**
7 **Commission's "no harm" standard?**

8 A. Yes.

9

10 **Q. Does this conclude your testimony?**

11 A. Yes.