BEFORE

THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Joint Application of Frontier Communications Corporation, New Communications Holdings Inc. and Verizon Communications Inc. for Consent And Approval of a Change in Control	))))))	Case No. 09-454-TP-ACO

MEMORANDUM OF THE JOINT APPLICANTS IN RESPONSE TO THE MOTION OF THE OFFICE OF THE OHIO CONSUMERS' COUNSEL TO DENY CONSENT AND APPROVAL OF THE CHANGE IN CONTROL OR, IN THE ALTERNATIVE, FOR THE IMPOSITION OF CONDITIONS ON MERGER, COMBINED WITH RESPONSE TO THE MOTION OF COMMUNICATIONS WORKERS OF AMERICA AND INTERNATIONAL BROTHERHOOD OF ELECTRICAL WORKERS, LOCAL 986 TO ESTABLISH A PROCEDURAL SCHEDULE

I. INTRODUCTION

Frontier Communications Corporation ("Frontier"), New Communications Holdings, Inc. ("NCHI") and Verizon Communications Inc. ("Verizon") (collectively, "Applicants") hereby respond to two motions: (1) the Motion To Deny Consent And Approval Of The Change In Control Or, In The Alternative, For The Imposition Of Conditions On Merger, filed by the Office of the Ohio Consumers' Counsel ("OCC") on August 18, 2009 (the "OCC Motion"); and (2) the Motion To Establish A Procedural Schedule, filed by the Communications Workers of America and International Brotherhood of Electrical Workers, Local 986 ("Unions") on August 17, 2009 (the "Union Motion").

As discussed below, the Commission should reject OCC's request to deny the Application or impose conditions. OCC presents no valid evidence of why the Application should be denied, and OCC's proposed conditions violate applicable law and Commission precedent. Additionally, given that the Commission's Entry of August 19, 2009 (the "August 19

Entry") set a procedural schedule, the Commission should dismiss the Unions Motion as moot.

II. ARGUMENT

A. The OCC Motion Should be Denied

1. *The OCC's claims of "risk" are unsupported.*

The OCC's claim that the Commission should deny the transaction is unsupported. OCC's principal contention is that the transaction involves "significant risks" that the Applicants have not disclosed. OCC Motion at 8. These "risks," according to OCC, arise from Frontier acquiring assets that Verizon "no longer wishes to maintain," from the fact that "a small company is swallowing a large part of a large company much larger than itself" (a circumstance that OCC states, without explanation, "carries risk"), and from Frontier's dividend policy. *See* OCC Motion at 9-13.

As a threshold matter, OCC provides no explanation or support for its claims. Simply characterizing an unsupported statement as a "risk" without any support does not make it so, and certainly does not require rejection of the Application. In fact, Frontier has a strong income statement and balance sheet and is financially qualified to complete the Verizon acquisition and to operate the acquired properties. The Direct Testimony of Daniel McCarthy, Frontier's Executive Vice President and Chief Operating Officer ("McCarthy Direct") explained that Frontier is a publicly traded communications company serving approximately 2.8 million voice and broadband connections, including 2.25 million telephone access lines in twenty-four states, with 2008 revenue of $2.2 billion. McCarthy Direct at 13. Mr. McCarthy further explained that Frontier has generated and will continue to generate increased free cash flows and that Frontier's leverage ratio (net debt divided by earnings before interest, taxes, depreciation and amortization, or EBITDA) is projected to decrease from 3.8 times to 2.6 times, which is approaching investment grade. McCarthy Direct at 24. This will provide Frontier with improved access to the capital markets, thereby increasing Frontier's flexibility to further manage its balance sheet and/or invest in new products for its customers. McCarthy Direct at 24-25; Supplemental Testimony of Daniel McCarthy ("McCarthy Supplemental") at 14-21. Mr. McCarthy also squarely addressed OCC's concern regarding the combination of the Frontier and Verizon operations by describing Frontier's successful track record of acquiring, operating and investing in telecommunications properties nationally, including over 750,000 access lines it purchased from Verizon's predecessor GTE between 1993 and 2000; subsequently, in June 2001, Frontier purchased all of Global Crossing's local exchange carriers, which served approximately 1.1 million telephone access lines in 12 states and how more recently Frontier acquired and successfully integrated Commonwealth Telephone Company (which comprised more than 400,000 access lines) in Pennsylvania and Global Valley Networks in California. McCarthy Direct at 55-56.

Mr. McCarthy's Supplemental Testimony also disproves OCC's suggestion of "risk" in relative size,[1] or in comparing this transaction to prior Verizon transactions.[2] The Frontier transaction is entirely different from the Fairpoint transaction referenced by OCC, as Mr. McCarthy explained in detail in both his Direct Testimony and Supplemental Testimony.[3] Fairpoint was required to create new, fully-functional systems to replace the Verizon operating support platform. Here, by contrast, Verizon will be transferring to Frontier the fully functional and scalable operating support systems that are used today in those exchanges in the provision of

[1] "A small company is swallowing a large past of a company much larger than itself." OCC Motion at 10.

[2] *Id.* at 9

[3] McCarthy Direct at 46-51; McCarty Supplemental at 29-37.

service. As a result, there is no need for Frontier to develop new operational, customer support, and financial systems, and then to cut over to the new systems at closing in order to operate the acquired properties.

As Mr. McCarthy also explained in his Supplemental Testimony, the published responses of independent research analysts to the proposed transaction have recognized how the proposed transaction is very different from the Fairpoint transaction. For example, on June 12, 2009, Raymond James and Associates, Inc. issued a report supportive of Frontier's ability to execute the transition effectively. The report stated:

> We note several significant differences between [this transaction and the FairPoint transaction]: Frontier is de-levering (not re-levering) significantly through the transaction, should be solidly in investment grade range, is proactively cutting its dividend, and plans on driving broadband penetration and availability much higher than current levels, (Verizon properties have 60% availability, Frontier's have 92%). . . .
>
> Frontier will acquire GTE's entire legacy IT systems in 13 of the 14 states, giving it the ability to run parallel systems for all products in those 13 states. This is different from a forced cutover or new systems development, which actually requires a hastened time frame and can be fraught with peril. Effectively, these are stand-alone systems with a general manager overseeing them and won't require any new systems development on the part of Frontier until management is ready to move them over. . . .
>
> Overall, we believe Frontier is making a prudent acquisition, which will expand its scale, lower its leverage, and improve its dividend sustainability, thus rewarding patient investors over time.[4]

In addition, in its Rating Action placing Frontier's corporate credit ratings on review for possible upgrade following the announcement of the proposed transaction, Moody's Investors Service indicated that "VZ-Spinco will be operating under independent management and operating systems prior to the merger effectiveness and will not require a timed cutover, which is

[4] Raymond James & Associates, FTR: Notes From the Road (June 12, 2009) (McCarthy Supplemental Exhibit DM-5).

expected to materially reduce the transition issues that other carriers have experienced."[5] It is also noteworthy that Fitch Ratings, in placing Frontier's credit ratings on Rating Watch Positive as a result of the proposed transaction stated that "Fitch believes the execution risk is offset to some extent by Frontier's significant experience in integrating large transactions and the scalability of its existing systems."[6] Clearly, these credit rating agencies, which tend to have a conservative perspective, believe that on balance the transaction is positive for the company from a financial perspective as opposed to being a financially risky proposition. The independent, unbiased assessments of analysts and credit rating agencies regarding the systems transition "risks" raised by OCC are compelling in their own right, and affirm Mr. McCarthy's testimony regarding Frontier's ability to avoid the problems encountered in the FairPoint transaction. Based on Frontier's experience, significant scope and scale, and the structure of the transaction, there is no new "risk" as asserted by OCC that merits rejection of or imposition of conditions on the proposed Frontier/Verizon transaction.

In fact, from the standpoint of overall size, this transaction is most comparable to the transaction between Embarq and CenturyTel that formed CenturyLink, which this Commission recently approved without conditions.[7] As Mr. McCarthy points out, the CenturyLink transaction involved acquisition of 5.8 million access lines; this transaction involves 4.8 million. Embarq was 2.87 times the size of its acquiror CenturyTel; Verizon is 2.13 times the size of

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[5] Moody's Investors Service, Global Research Rating Action: Frontier Communications Corporation (May 13, 2009) (McCarthy Supplemental Exhibit DM-1).

[6] Fitch Ratings, Fitch Places Frontier Communications on Rating Watch Positive (May 13, 2009) (McCarthy Supplemental Exhibit DM-2).

[7] McCarthy Supplemental at 27-29. The Embarq/CenturyTel transaction was approved in Case No. 08-1267-TP-ACO.

Frontier.[8] Thus, OCC's innuendo that would paint this transaction as an unusual and "risky" combination of large and small is simply wrong; this transaction bears close resemblance to recent, similar transactions that this Commission has found to "promote the public convenience."

In addition, as Mr. McCarthy also explains in his Supplemental Testimony, much of the alleged "risk" identified by OCC is either illusory or the product of OCC's error. For example, OCC contends that Frontier has "paid dividends through long term debt," and inappropriately focuses on Frontier' net income.[9] In alleging that Frontier ever used long-term debt to pay dividends, OCC is incomplete and inaccurate. OCC's analysis regarding Frontier's debt includes Frontier's borrowings but, inexplicably, omits Frontier's debt *payments*, and fails to consider that Frontier's outstanding debt level has remained relatively constant. McCarthy Supplemental at 21.

OCC also erroneously focuses on net income in considering Frontier's dividends, when in fact the appropriate analysis should evaluate dividend payments in relation to free cash flow. Book net income can contain numerous non-cash entries, like depreciation, amortization, pension expense and income taxes, that make this line item a less-than-accurate indicator of the actual cash generated by the business. In addition, booked net income excludes capital expenditures – a major use of cash in the ILEC business.[10] Contrary to OCC's assertion, Frontier's current financial health is very sound. As illustrated in Mr. McCarthy's Supplemental Testimony,

[8] McCarthy Supplemental at 28.

[9] OCC Motion at 12.

[10] Frontier's Board of Directors and management have considered available cash flows, capital needs, and debt service requirements and have planned a dividend payout policy (which is dividends as a percentage of free cash flow, not as a percentage of net income) for the pro forma combined company (based on an annual dividend of $0.75 per share, down from the $1.00 per share paid to Frontier shareholders pre-transaction) that will enable Frontier to Company to attract sufficient capital to fund (to the extent necessary) investment, operations, and service of other capital. McCarthy Direct at 23-24. Frontier's post-transaction proposed dividend payout ratio is expected to be 43% including expected cost savings (52% before these savings are achieved). *Id.*

Frontier's free cash flow generation exceeds its dividend payments and capital expenditures.[11] As that data explains, Frontier's recent operations have generated free cash flows that ranged from $493 million to $562 million per year.[12] Contrary to OCC's allusion, these cash flows do not include funds from financing activities. They are cash flows *after* network investments which, as Mr. McCarthy noted in his Direct Testimony, have been sufficient to allow Frontier to provide broadband service availability to over 90% of the households in its very rural national service territory.[13] So, when viewed in relation to free cash flow, and not in relation to book net income as OCC proposes, Frontier's dividend policy is both sustainable and financially responsible within the industry in which it operates. Again, an objective review of the data demonstrates that Frontier is financially healthy now and is expected to be stronger still with the closing of the proposed transaction.

In short, the issues raised by OCC are addressed both in the Applicants' Initial Testimony filed on July 9, 2009, and in their Supplemental Testimony of September 8, 2009. In each instance, the Applicants have demonstrated (a) Frontier's qualifications to operate the network assets that are subject to the Transaction and (b) the measures taken by the Applicants jointly to assure a smooth and seamless transition from Verizon's operations to Frontier's. The Applicants have established "that the acquisition will promote public convenience and result in the provision of adequate service for a reasonable rate, rental, toll, or charge." Revised Code §4905.402. The OCC's Motion provides no basis to deny the Application, and it must be denied.

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[11] *See* McCarthy Supplemental at 15.

[12] *Id.*

[13] McCarthy Direct at 18.

2. *The OCC's proposed conditions are unlawful.*

The OCC proposes three conditions for approval of this transaction: ubiquitous broadband access; a residential rate reduction of $1.25 per month; and service quality monitoring and enhancement. OCC Motion at 18-28. Imposing such conditions would be contrary to law and Commission precedent, and should be rejected.

The Commission has long held that where it lacks jurisdiction to *order* a utility to take a given action, it likewise lacks authority to *require* such an action as a condition to approval under Revised Code §4905.402. *See, e.g.*, *In the Matter of the Joint Application of SBC Communications and AT&T Corporation*, Case No. 05-269-TP-ACO, Finding and Order at 36 (November 4, 2005); *see also* *In the Matter of the Matter of the Joint Application of Verizon Communications Inc. and MCI Inc.*, Case No. 05-497-TP-ACO, Finding and Order (November 29, 2005). Here, the Commission does not have authority to impose any of OCC's proposed conditions.

First, the Commission has no authority over broadband under Revised Code §4905.042:

> Regarding advanced services or internet protocol-enabled service as defined by federal law, including federal regulations, the public utilities commission shall not exercise any jurisdiction over those services that is prohibited by, or is inconsistent with its jurisdiction under, federal law, including federal regulations.

The broadband services that OCC proposes to require as a condition are precisely the advanced, interstate services that are beyond the Commission's jurisdiction. Accordingly, the Commission cannot impose any broadband condition.[14]

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[14] OCC is correct that the Applicants (and specifically Frontier) have identified and described their intentions concerning broadband deployment, but those statements do not and cannot confer jurisdiction on the Commission to *order* as much.

Second, the Commission does not have the authority to order local-service rate reductions here. Both Verizon North and Frontier operate under alternative regulation in Ohio,[15] and their retail rates are therefore governed by the Commission's alt-reg rules.[16] The Commission has no independent power (or justification) for reducing Verizon North's rates now, and likewise has no jurisdiction (or justification) for reducing rates when the transaction is completed.

In any case, as OCC concedes,[17] OCC agreed to the $1.25 charge that it now attacks, and OCC was well aware that it was not a temporary surcharge. Further, although Verizon's access minutes may be lower than they were in 2006, Verizon has fewer access lines than it had when the $1.25 charge was originally determined, and so the charge recovers less of the access shortfall than it did when introduced. All in all, given these considerations and the alternative regulation that governs the rates in question, the Commission must reject OCC's request here, just as it did when OCC made a similar request in the CenturyLink proceeding. *See In the Matter of the Joint Application of CenturyTel, Inc. and Embarq Corporation*, Case No. 08-1267-TP-ACO, Opinion and Order at 10 (February 25, 2009).

Third, the Commission cannot order service quality or "enhancement" conditions, including OCC's proposal to monitor retail service quality and improve performance in up to 25 exchanges, because no evidence exists to support such conditions. As a result, in lieu of such evidence, the OCC Motion relies on innuendo and flawed analogy – the only "evidence" cited by OCC to support its proposal is a prior service quality proceeding involving Verizon that was resolved and is no longer pending, OCC's interpretation of various federal ARMIS reports that

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[15] *See* Case Nos. 06-0770-TP-ALT (Verizon North) and 07-0542-TP-ALT (Frontier).

[16] Ohio Administrative Code Chapter 4901:1-6.

[17] OCC Motion at 24-25.

do not reflect Ohio service quality standards, and a single consumer complaint.[18]

Service quality is addressed in the Applicant's Initial and Supplemental Testimony, which demonstrate both Frontier's expertise in managing service quality and the efforts of the parties to assure continuity for customers.[19] Frontier will have every incentive to provide the highest service quality, and has repeatedly stated its intention to do so. Frontier should not be subject to increased or unique service quality requirements. To order otherwise would be to single out Frontier and establish unique and disparate service quality standards without justification. The Commission cannot lawfully do so.

Finally, despite OCC's protests to the contrary, the Commission cannot establish the conditions proposed by OCC without exceeding its jurisdiction. As noted, Commission precedent holds that where the Commission lacks jurisdiction to *order* a utility to take a given action, it likewise lacks authority to *require* such an action as a condition to approval under Revised Code §4905.402. In response, OCC claims that the Commission's previous decisions that so held were "erroneous," and further claims that the Commission found otherwise in prior merger cases.[20] OCC is wrong. In the prior merger cases cited by OCC, the applicant telephone companies either proposed the conditions that were ordered or agreed to them.[21] They did not arise unannounced or become imposed over the objection of the telephone companies, as the

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[18] OCC Motion at 26. The consumer complaint cited by OCC is *Turnbull v. Verizon North*, Case No. 09-571-TP-CSS. In an Entry of September 3, 2009 in that case, the Commission has now observed that the complainant-customer would be withdrawing its complaint.

[19] Verizon's prior service-quality issues resolved in Case No 07-511-TP-UNC are just that: resolved. As a result, they are irrelevant here, and certainly irrelevant to Frontier.

[20] OCC Motion at 15, citing decisions reached with the transactions involving Ameritech and SBC, Case No. 98-1082-TP-AMT ("Ameritech/SBC") and GTE and Bell Atlantic, Case No. 98-1398-TP-AMT. ("GTE/BA").

[21] Ameritech/SBC was resolved by Stipulation; the GTE/BA conditions were proposed by the applicants in amended and supplemental testimony and adopted by the Commission order, to which the applicants did not thereafter object. *See* Case No. 98-1398-TP-AMT, Opinion and Order at 6 (February 10, 2000).

OCC argues.

Further, the Commission cannot simply reverse as "erroneous" its established precedent concerning conditions under Revised Code §4905.402, as the OCC appears to propose. The Commission is bound to its own precedent as is any other administrative agency, and Ohio law requires its observance. *Consumers' Counsel v. Pub. Util. Comm'n* (1984) 10 Ohio St.3d 49, 51, *citing Cleveland Electric Illuminating Co. v. Pub. Util. Comm'n (1975) 42 Ohio St.2d 403, 431*: "[The Commission] should respect its own precedents in its decisions to assure the predictability which is essential in all areas of the law, including administrative law."

Finally, even where the Commission has jurisdiction over proposed conditions, the Commission has held that any such conditions must bear a direct connection to the transaction at issue. *See, e.g.,In the Matter of the Joint Application of Verizon Communications Inc. and MCI, Inc.*, Case No. 05-497-TP-ACO, Opinion and Order at 58 (November 29, 2005). Otherwise the Commission would be acting on caprice or fiat, not on the reasoned decision-making required by Revised Code Title 49.[22] This transaction will have but one result: a new owner for a local-exchange business in Ohio. None of OCC's proposed conditions, including its service quality conditions, bear any relation to that result, and must therefore be rejected.

B. The Union Motion To Establish A Procedural Schedule is Moot.

On August 17, 2009, the Unions moved the Commission to set a procedural schedule and to convene hearings before ruling on the Application. In its August 19 Entry, the Commission set a schedule and established hearings. Thus, the Union Motion is therefore moot.

[22] Among other things, the Commission must justify its decisions based on the record before it, Revised Code §4905.09.

III. CONCLUSION

For the reasons set forth above, the Commission should:

1. Find that the Unions' Motion to Establish a Procedural Schedule is moot;

2. Deny OCC's Motion requesting that the Application should be denied;

3. Deny OCC's Motion to impose the requested conditions; and

4. If the Commission finds that it has authority to impose any condition, reject the condition as unwarranted and without foundation in these proceedings.

Respectfully submitted,

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that a copy of the foregoing was served by electronic service and/or first class mail, postage prepaid, on the parties listed below on this 8th day of September, 2009.

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