A New Era in ILEC Transfers: Safeguarding Wireline Telecom Service

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The views and opinions expressed herein are those of the author, and do not necessarily represent those of either NRRI or her colleagues at ETI.

Online Access

This paper can be accessed online at http://www.nrri.org/pubs/telecommunications/ILEC_transfers_nov09-15.pdf.

From the Executive Director

Helen Golding, the author of *A New Era in ILEC Transfers: Safeguarding the Public Interest*, is Vice President of Economics and Technology, Inc. (ETI), a well-established professional consulting firm. Prior to joining ETI she worked as a Telecommunications Specialist and later as Assistant General Counsel for the Massachusetts Department of Public Utilities. She was also employed as a General Attorney in the then Common Carrier Bureau of the Federal Communications Commission, and later was Chief Regulatory Counsel and Manager of Telecommunications Public Policy for Honeywell, Inc. I selected ETI for this paper because of its professional expertise and its wide range of clients and client experiences.

The paper (a) empowers regulators to think for themselves; and (b) confines its advocacy to advocacy for alertness, not for a particular outcome. At the same time, I know well, from 30 years in regulatory politics, that people have different perspectives about what issues warrant regulatory concern. I wish to ensure that NRRI honors those different perspectives, if offered consistently with NRRI's central purpose: to help regulators see issues clearly and decide them objectively.

While Ms. Golding states that the views and opinions expressed in the paper are her own and do not necessarily represent those of NRRI or her colleagues at ETI, I recognize that others may view these issues differently. Accordingly, I have decided to publish this paper accompanied by an invitation for those with different perspectives to contribute their thoughts—either in the form of a comprehensive paper responding to this one, or in the form of comments on this paper. Provided those contributions satisfy professional standards and do not argue for non-scrutiny of the issues set forth in the paper, but instead help decisionmakers understand issues better, I will publish a sample of them on our website no later than January 15, 2010.

This paper's main argument is that the public interest requires regulatory review of the transaction types described therein. An insistence on alertness is not a departure from objectivity; it is an application of objectivity. As was intended, and as its title conveys, the paper focuses on what might go wrong in these transactions. NRRI's limited resources are best directed toward matters that receive insufficient attention. I welcome others to argue for regulatory attention to the benefits.

Scott Hempling, Esq.
Executive Director
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Executive Summary

To focus on selected segments of its diverse telecommunications business, Verizon Communications, Inc., the second largest U.S. incumbent local exchange carrier (ILEC), has begun to sell off the part of its business that provides traditional wireline local exchange and intrastate toll services. Although no specific plans to follow Verizon's lead have been announced by either AT&T or Qwest, one cannot discount that possibility.

The size and scope of these changes in control and ownership (a) distinguish them from earlier ILEC sales that typically involved individual or a relatively small group of exchanges, and (b) increase the need for a thorough public interest inquiry by state commissions. FairPoint Communications, which acquired Verizon's wireline telephone business in Maine, Vermont, and New Hampshire in 2008, has struggled financially and operationally, and has recently declared bankruptcy. Hawaiian Telcom, which Verizon sold to a private equity group in 2005, has also declared bankruptcy. Verizon now proposes to sell its wireline telephone business in West Virginia and in 13 of the former GTE jurisdictions to Frontier Communications.

As we write, regulators are deliberating upon these transactions. This paper addresses four main questions central to those deliberations:

- In the type of transaction contemplated by Verizon and Frontier, how and to what extent do the private interests of the transferor and transferee diverge from the public interest, and what is the responsible role for regulation when private behavior diverges from the public interest?

- What are the substantive areas requiring regulatory alertness (during ownership transition; and during the short- and long-term, post-transition)?

- In reviewing these transactions, what are effective processes by which regulators can create the factual record necessary to serve the public interest?

- What are the commission's options if a proposed transfer raises public interest concerns?

Notwithstanding changes in technology that have given customers alternative telecommunications services, the wireline local distribution facilities owned and operated by the ILEC retain unique ubiquity and reliability that make them essential to the public interest. Wireline local exchange and exchange access services continue to be necessary for residential and business customers, for the provision of wireline and wireless telecommunications services by ILEC competitors, and for other public health and safety objectives. Regulation continues to be required to ensure that the ILEC provides wireline local exchange and exchange access services in a manner consistent with the public interest.

Like other transfers, the particular ILEC transfers discussed here require regulatory approval. The transfer initiates with a private agreement between buyer and seller, aimed at achieving of their respect private interests. Private interests may or may not be consonant with public interest goals. After identifying if and, if so, where private and public interests diverge in a proposed transfer, the regulator can determine whether the proposed transfer can be approved or approved with conditions, or whether it must be rejected outright.

The substantive review of the recent and proposed transfers from Verizon to FairPoint and Frontier—and other similar transfers that may occur in the future—must take account of the significant differences in size, sophistication, and industry experience of the seller and buyer. By every relevant telecommunications industry metric, Verizon is either the first or second largest U.S. telecommunications company. Its financial performance has been strong and sustained. Most of its senior managers have spent their entire careers in the telecommunications industry. Prior to its acquisition of Verizon's northern New England businesses, FairPoint operated just over 300,000 access lines; the acquisition of the Verizon business instantly gave FairPoint control of 1.8 million lines, resulting in a six-fold increase in size. Even before the transfer, FairPoint had obvious financial weaknesses; with the additional demands placed on it by the large acquisition, FairPoint's financial condition deteriorated, forcing it to declare bankruptcy. Even with help from an outside consultant, FairPoint was unable to accomplish a smooth transition from Verizon's operation support systems to new systems designed to meet FairPoint's requirements. This inability resulted in wide-ranging service-quality and billing problems. FairPoint's size alone did not predict its failure, but it did raise concerns with regulators about whether the company's financial, managerial, and technical qualifications were sufficiently robust to increase the size of its business by 500%. Similar concerns present themselves in the pending Verizon sale to Frontier of Verizon's former GTE operating company assets in 13 states, along with Verizon's former Bell Atlantic holdings in West Virginia; these Verizon assets are twice Frontier's current size and more than four times larger than its largest previous acquisition.

Even an otherwise capable buyer can be undermined by a disadvantageous business transaction. Given recent experience with other Verizon exchange sales, the regulator cannot assume that a small, less sophisticated buyer understands the private interests of the seller or how those interests shape the terms of the sale In order to protect the public interest, the regulator needs to confirm that the terms of the sale and transfer convey assets at a fair value, that the assets conveyed are sufficient to form the basis for a financially successful business, and that the terms of the agreement ensure a smooth operational transition from existing provider to the new ILEC.

After examining the terms of the deal, the regulator needs to make certain that the buyer has and can be expected to maintain the requisite **financial condition** and **managerial and technical skills** to operate the ILEC consistent with the public interest. In each of these categories, regulators must consider not only the buyer's track record and existing qualifications, but also the size of the expansion and its anticipated effects on the buyer. At the same time, the regulator must ascertain the likelihood that the buyer has the necessary human and financial resources to fulfill any future commitments that are essential to public interest requirements. Such commitments might include promises of broadband deployment, management responsiveness, rate stability, or improved service quality.

The final two sections of this paper address the process for gathering information necessary to make a sound decision and the issues that confront regulators if and when their investigation of the proposed transfer exposes public interest concerns. With or without a statutory deadline, there is often pressure on regulators to reach a decision expeditiously, in part because the business conditions underlying the proposed deal will change over time. The public interest requires, however, that regulators have sufficient time to acquire the relevant evidence, deliberate, and prepare a sound legal decision. To help ensure that the investigation proceeds efficiently and stays focused on public interest concerns, the regulator must maintain control throughout the proceeding, starting with specific instructions for the contents of the initial applications and ending with a process for addressing gaps in the evidentiary record.

Upon conclusion of its investigation, the regulator must decide whether to approve the transfer. Unconditional approval requires that the regulator find that the transfer is in the public interest and satisfies all statutory criteria. Frequently, regulators cannot make this finding, due to data gaps or uncertainty about the future. When the regulator decides to impose conditions to remedy specific problems that it has identified with the proposed transfer, it must be able to match the conditions to its specific concerns and ensure that compliance is measurable and enforceable. If there is no way to craft conditions that meet these goals, the public interest requires rejection of the transfer.

A closing note with respect to recent proceedings that are discussed in this paper: It is clear from their orders that the New England commissions were thorough in their investigation of the Verizon-FairPoint sale. They identified many of the potential weaknesses in the transaction and the conditions that they adopted addressed many important areas of vulnerability. Although in hindsight it may turn out that these conditions were not sufficient to cure the deficiencies in the transfer, the purpose of this paper is to learn from and not to second-guess the decisions that have been made.

Table of Contents

List of Tables

A New Era in ILEC Transfers:

Safeguarding Wireline Telecom Services

I. Introduction

An earlier NRRI paper, addressing private equity buyouts of public utilities, succinctly captures the role of regulation in aligning the private and public interests:

> Utility regulation is designed to duplicate the market discipline imposed by competition. Regulation thus supports the interests of both investors and ratepayers by setting rates that recover prudently incurred costs, including the cost of capital. The utility can then fund its ongoing, efficiently-managed operations and attract the capital to build the facilities necessary to fulfill its obligation to serve the public at the lowest reasonable cost. In this regulatory process, the public interest is paramount. That is, there are private interests (e.g., ratepayers' desire to receive utility service at little or no cost, investors' desire to receive a high return with little or no risk) that do not serve the public interest of providing ubiquitous service at reasonable cost. Regulation reigns in private interests where necessary in favor of the broader public interest of providing the utility services required by society at the lowest reasonable cost. Only in that way are the societal benefits of utility service maximized.[1]

In the current paper, we apply this framework to the regulatory review of another specific type of transfer of control. This paper focuses on the recent transfers of control of wireline local exchange and intrastate telecommunications businesses by a large, highly integrated national ILEC[2] to new owners who have direct experience in the business they seek to acquire, but on a very much smaller scale and scope.

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[1] Stephen G. Hill, *Private Equity Buyouts of Public Utilities: Preparation for Regulators*, National Regulatory Research Institute (07-11) (December 2007).

[2] The term "large ILECs" as used in this paper refers to the three surviving Bell operating companies, which are distinguishable in size and scope of operations from any of the other U.S. ILECs. In 1996, the seven regional Bell holding companies, together with GTE Corp. and Sprint, owned over 90% of the local exchange access lines in the U.S. (calculated from data contained in the FCC *Statistics of Common Carriers*, 1998/1999 Edition). Through a series of mergers, this number has been reduced to three: AT&T (which combines the former SBC, Pacific Telesis, Ameritech, and BellSouth BOCs, plus Southern New England Telephone and legacy AT&T), Verizon (which combines the former NYNEX and Bell Atlantic, plus GTE Corp. and MCI) and Qwest (which purchased US West). Prior to the Hawaii and northern New England divestitures, Verizon served 31% percent of ILEC wireline access lines, AT&T 45%, and Qwest 9% (FCC, *Trends in Telephone Service*, 2008 Edition).

These recent sales, and those currently under regulatory review, are unlike many of the telephone company transfers of control that state commissions have previously reviewed. In the mergers of the regional Bell operating companies in the late 1990s,[3] or the subsequent SBC-AT&T and Verizon-MCI mergers that became final at the close of 2005 and beginning of 2006, respectively, one telecommunications giant absorbed another. In the typical sale of exchanges in the 1990s, the Bell regional holding companies (particularly Qwest) sold off selected rural exchanges, not its entire statewide holdings; the buyer was exclusively involved in serving rural areas; and the transfer resulted in the buyer qualifying for high-cost support from the federal universal service fund that was unavailable to the seller.[4]

The recent and pending sales of state local exchange operations by large ILECs differ in size and kind from these prior transactions in several key ways:

- Large blocks of exchanges—in some cases the entirety of the parent company's operations in a state—are being transferred; thus, the consequences of not getting it right will have a broader geographic and economic impact than for transactions involving a small number of isolated communities.

- The buyer is considerably smaller, in terms of size, scope, financial strength, and managerial experience, than the seller.

- In some cases, the specific assets, customers, services, and even geographic markets that are proposed to be divested exclude the highest-margin, highest-revenue, and fastest-growing components of the (pre-divestiture) ILEC's operations, thereby diminishing the purchaser's revenue, profit, and growth opportunities as soon as the transaction closes.

- The transactions frequently involve a significant increase in overall leverage (i.e., debt-to-equity ratio) on the part of the purchaser, often requiring commitments to large new debt financing and debt service, such that the post-transaction purchaser will be in a substantially weaker financial condition with respect to the exchanges being purchased than the seller had been with respect to those same assets.

This paper focuses primarily on the issues raised by the pending transfer of wireline assets and operations in 14 states from Verizon Communications to FairPoint Communications. It also draws on the recent (approved) transfer of control of other Verizon wireline assets and operations in Maine, New Hampshire, Vermont, and Hawaii.

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[3] SBC-Pacific Telesis (1997); Bell Atlantic-NYNEX (1997); SBC-SNET (1998); SBC-Ameritech (1999); Bell Atlantic-GTE (2000). Subsequent to acquiring AT&T and taking its name, the former SBC also acquired BellSouth (2006).

[4] For background on high-cost universal service fund support, see Peter Bluhm, *Fundamentals of Telecommunications Regulation: Markets, Jurisdiction, and Challenges*, NRRI, 2008 (chapter IV). NRRI will publish a major paper on state universal service funds in January 2010.

Some of the key operational and financial attributes of the proposed Verizon-Frontier transaction are set forth in Tables 1 and 2 below.[5]

Table 1
Summary Financial and Operational Data
(Data Pro-forma for Year End 2008)

	Pre-Acquisition Frontier	**Post-Acquisition Frontier Pro-Forma**
Access Lines	2.25 million	7.05 million
States	24	27
States with more than 500,000 lines in service	1	7
Employees	5,671	16.000
Revenue	$2.25 billion	$6.52 billion
EBITDA	$1.20 billion	$3.125 billion*
"Free Cash"	$493 million	$1.43 billion*
CAPEX	$290 million	$700 million
Net Debt	$4.55 billion	$8.00 billion
Dividend / Share	$1.00	$0.75
Shares Outstanding	312 million	989 million
Net Leverage (Debt vs EBITDA)	3.8x	2.6x
Equity Value	$2.42 billion	$7.67 billion

* Does not include estimated "synergy" cost savings of $500 million.
SOURCE: "Welcome to the New Frontier" Slide Presentation dated May 13, 2009, available at the Frontier Communications Website, Investor Relations page, http://phx.corporate-ir.net/phoenix.zhtml?c=66508&p=irol-irhome

The state regulatory reviews of the Verizon-Frontier transfer will address many common elements, but some specific public interest concerns will vary because of state-specific facts.[6]

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[5] For tax reasons, Verizon is using "Reverse Morris Trust" to accomplish its sale of assets to Frontier. Verizon will spin off the designated assets to a temporary subsidiary known as "Spinco;" Spinco will then transfer the assets to Frontier.

[6] For example, in three states where Frontier had no previous presence, the transfer would give it control (in aggregate) of nearly one million lines. By contrast, in Arizona, Frontier would increase its in-state operations by only 4%; however, if the transaction puts financial and managerial stresses on the company it could affect Frontier's existing Arizona customers. Frontier also operates in three states where no additional lines would be acquired through the transaction. Although there is no jurisdictional asset transfer for those states' commissions to review, service to customers in those states could be affected by the major expansion Frontier proposes to undertake.

Table 2
Frontier's Proposed Acquisition of Exchanges from Verizon Would More Than Triple the Number of Lines Served

	Access Lines		
	Frontier	**SpinCo**	**Combined**
West Virginia	143,982	617,036	761,018
Indiana	4,647	718,251	722,898
New York	683,880	—	683,880
Illinois	97,461	573,321	670,782
Ohio	552	634,153	634,705
Washington	—	578,506	578,506
Michigan	19,102	507,462	526,564
Pennsylvania	427,489	—	427,489
Wisconsin	62,007	281,350	343,357
Oregon	12,626	309,904	322,530
North Carolina	—	263,479	263,479
Minnesota	210,983	—	210,983
California	143,871	24,205	168,076
Arizona	145,241	6,297	151,538
Idaho	20,035	113,002	133,037
South Carolina	—	127,718	127,718
Arizona	23,701	35,989	59,690
Tennessee	79,014	—	79,014
Iowa	44,891	—	44,891
Nebraska	43,106	—	43,106
Alabama	25,890	—	25,890
Utah	21,718	—	21,718
Georgia	19,167	—	19,167
New Mexico	8,001	—	8,001
Montana	7,659	—	7,659
Mississippi	5,474	—	5,474
Total:	2,254,333	4,790,673	7,045,006

SOURCE: "Welcome to the New Frontier" Slide Presentation, dated May 13, 2009, available at the Frontier Communications Website, Investor Relations page, http://phx.corporate-ir.net/phoenix.zhtml?c=66508&p=irol-irhome

It is not the purpose of this paper to address the specifics of any particular proceeding; moreover, it would be impossible to synthesize in one document all of the different variables being examined in these cases. Rather, the objective is to examine categories of key issues that regulators need to examine to arrive at a decision in the public interest. Aided by this identification of issues, regulators in each examining state can ask the necessary questions and thus make alert public-interest decisions.

II. In the Proposed Transactions, Do the Private Interests Diverge from the Public Interest?

A. Elements of the public interest

In this paper, we focus upon how the public interest may be affected by a transfer of control of an ILEC. We emphasize actions regulators can take in the review process to prevent the divergence of private and public interests. Two primary attributes form the foundation for public utility regulation: "(1) special public importance or necessity and (2) the possession of specific physical and human assets like utility plants, distribution networks, and technical expertise that lead almost inevitably to monopoly or at least to ineffective forms of competition."[7] Utility regulation addresses concerns about monopoly or ineffective competition. A broader range of regulatory responsibilities emanates from the concept that the service is a "necessity"—including ensuring service availability, service quality, and the financial stability of the utility. At times, social goals also are superimposed on regulatory frameworks and expand the scope of what is considered to be the public interest.

The statutes that require prior regulatory authorization for a transfer of control of an ILEC's franchise date from a time when there was no question that local exchange telephone service met the definition of a public utility service, requiring regulation consistent with the public interest. This conclusion is not as obvious today. Some argue that the local wireline local distribution (exchange access) facilities no longer retain their special public importance because of the existence of alternative telecommunications technologies (so-called "intermodal" platforms), and that the emergence of new local distribution facilities proves the feasibility and existence of effective competition. To protect the public interest with respect to the ownership and operation of ILEC wireline franchises, the regulator needs to be convinced that (a) the public continues to require the availability of wireline local exchange services, (b) such competition as may be present does not itself depend on the incumbent's network infrastructure and resources for its own (competing) services, and (c) whatever competition exists is insufficient to constrain the incumbent's prices and/or ensure reliable local exchange service.

This paper is predicated upon the conclusion that the local wireline telecommunications facilities owned by the incumbent LEC are unique and essential. None of the competitive

[7] James C. Bonbright, Albert L. Danielsen, David R. Kamerschen, *Principles of Public Utility Rates*, Public Utilities Reports, Inc. (1988), pp. 14-15. This is a very simplified version of the rationale for public utility regulation in the public interest, which Bonbright *et al.* examine in much more detail in the opening chapters of their treatise.

providers or services has facilities that are as ubiquitous as the ILEC's. Even where they are available, the telecommunications services provided by intermodal competitors such as wireless and cable can fail to serve as effective substitutes for wireline telecommunications services, because of differences in price, quality, functionality, or security. Moreover, competitive providers (including wireless), whose services some perceive as substitutes for traditional local exchange service, themselves rely extensively upon wireline local exchange facilities as the primary means for interconnecting their hundreds of thousands of transceiver sites (industry-wide) to the wireless carriers' switching offices.[8] There are also specific public interest functions, such as E-911, that "intermodal" telecommunications services cannot presently provide as accurately or reliably as services provided over ILEC wireline facilities. For all these reasons, ample justification exists for regulation intended to ensure that whoever owns or controls the ILEC can and will operate in a manner that is consistent with the public interest.

The public interest requires the ILEC to provide to the public telecommunications services that meet the public's needs, at reasonable prices based upon the ILEC's efficient operation of its business. However, consistent with the ILEC's constitutional property rights and the necessity of the service it provides, the public interest also protects the long-term stability of a prudent ILEC's business by providing the utility with the opportunity to recover its reasonably incurred costs, plus a profit commensurate with risk. In other words, while consumers would prefer the lowest possible rates, the concept of a "just and reasonable" rate allows for the countervailing (but equally important) interest of ensuring that the prudent service provider is financially stable, so that it can continue to fulfill its service obligation.

Specific policies, adopted through state and federal legislation, must necessarily inform regulators' thinking with respect to the public interest. So, for example, the federal Communications Act of 1934 supports the concept of "universal service," recognizing the broad benefit to society of having all households and businesses connected to a common public national telecommunications network.[9] In addition, the notion of what types of telecommunications consumers should be able to purchase as "basic" services protected by the "universal service" principle has evolved with the introduction of new technology, as well as

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[8] Sprint, for example, has advised the FCC that some 99% of its 52,000 cell sites nationwide have no competitive alternative to ILEC facilities to provide connectivity to the MTSO. *In the Matter of A National Broadband Plan for Our Future*, GN Docket No. 09-51, Comments of Sprint Nextel Corporation, June 8, 2009, at 13-14.

[9] Communications Act of 1934, as amended, 47 U.S.C. 151 (establishing the Federal Communications Commission "[f]or the purpose of regulating interstate and foreign commerce in communication by wire and radio so as to make available, so far as possible, to all the people of the United States, without discrimination on the basis of race, color, religion, national origin, or sex, a rapid, efficient, Nationwide, and world-wide wire and radio communication service with adequate facilities at reasonable charges, for the purpose of the national defense, for the purpose of promoting safety of life and property through the use of wire and radio communication, and for the purpose of securing a more effective execution of this policy by centralizing authority heretofore granted by law to several agencies and by granting additional authority with respect to interstate and foreign commerce in wire and radio communication….").

with changing social norms about what constitutes a customer's community. Service quality requirements have also evolved based on customer needs (as society has become increasingly dependent upon both voice and data telecommunications for social intercourse and commerce) and provider capabilities (as technology has lowered costs and improved performance and overall reliability).[10] In addition, ILECs' public service obligation has been extended to include providing the capability to support identification of customer location by first responders (the E-911 service). Any assessment of proposed dispositions, therefore, must take into account, and promote, a public interest that is flexible and evolving.

In the context of these proposed transfers of ILEC control, the regulator's assessment requires several key determinations:

- Is it in the public interest for the regulator to relieve the incumbent of its public service obligation?
- Relative to the seller, is the buyer is at least comparably qualified to take over that obligation?
- Are the specific terms of the transfer such that the transaction itself is consistent with the public interest?

For the regulator to approve the transaction as consistent with the public interest, all three of these conditions must be satisfied.

The evidence necessary to make these judgments can be difficult to obtain. The regulator is required to compare a known incumbent with an unfamiliar replacement. The incumbent has a track record, whereas the buyer's performance will occur in the future. Much of the available information about the buyer relates to its condition as of the date of its application for approval of the transaction and for a certificate of public interest and necessity. Relying mostly on the buyer's history as a guide, the regulator must make an informed extrapolation as to how the buyer will perform under its post-transaction financial condition and scale and scope of operations in carrying out its public interest obligations.[11] Where there is insufficient evidence

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[10] A threshold determination needs to be made about which services are affected with the public interest.

[11] This distinction is not always accepted by the applicant, however. In its December 2007 order rejecting the Verizon-FairPoint transfer, the Vermont Public Service Board (Vermont PSB) noted its disagreement with FairPoint's attempt to limit the standard of review as follows: "FairPoint argues that the principal question is not whether Verizon's customers and the state will be better off as a result of the transaction. Rather, FairPoint sees the principal issue as whether it has the technical, managerial and financial capabilities to fulfill its express commitments." *Joint Petition of Verizon New England Inc., d/b/a Verizon Vermont, certain affiliates thereof, and FairPoint Communications, Inc. for approval of an asset transfer, acquisition of control by merger and associated transactions*, Docket 7270, Order (December 21, 2007) (hereinafter, Vermont PSB FairPoint Rejection Order). After Verizon and FairPoint modified the terms of their transaction and entered into a settlement with the Vermont

to reach this conclusion, the regulator cannot simply rely on promises and predictions, but must defer approval until that evidence arrives.

B. Private interests associated with the sale of wireline franchises

The seller and buyer both want to strike the deal that produces the greatest financial benefit for their respective shareholders, while also protecting the interests of existing and new lenders and furthering the interests of management. They also both, of course, wish to demonstrate that the transaction satisfies all applicable legal standards. Each company's management has considered and adopted particular strategies that it believes will lead to this result and has determined that the proposed sale/acquisition of the ILEC's wireline business supports these strategies. While being constrained by such public interest obligations as may be imposed upon them under applicable law and regulation, as private companies the seller's and buyer's primary obligation is to their respective shareholders. Where there is tension between the unregulated private interest and the regulatory requirements for the public interest, the regulator must be especially alert to prevent the former from prevailing over the latter.

***Seller's interests*:** Traditionally, regulatory scrutiny in a transfer of control review focuses upon the buyer—the entity that will be responsible for providing the telecommunications service going forward. However, the seller's interests also affect the transaction. Except under conditions of financial distress (e.g., bankruptcy), the seller controls when and what to sell, and whom to sell to. The seller has superior knowledge of the business it is selling and of the value of assets and lines of business it proposes to exclude from the sale. To the extent that there is potential for post-transaction potential competition between seller and buyer, the seller is motivated to choose a buyer that will be a less effective competitor than other potential choices—an outcome inconsistent with the public interest.

Unlike the buyer, who hopes to derive its value from the sale through the ongoing operation of the business, the seller often takes away its value-share of the transaction up front. Most often, unless a separate authorization is required for the seller to discontinue service, the sale also terminates any authority the regulator has to require that the seller operate consistently with the public interest. Later in this paper, we discuss possible ways for the regulator to maintain some of the seller's obligations until the transfer can be deemed successful from a public-interest perspective.

***Buyer's interests*:** If the buyer is expanding its wireline operations in the state or in a multistate area, it likely hopes to increase operating efficiencies and profits. The buyer, like the previous incumbent, will look for opportunities to increase profits by raising rates, absent regulatory limits or, where present, competitive constraints. Cost-cutting measures are another way of increasing profits. Where cost cutting results from operational efficiencies or the deployment of more efficient technologies, it advances the public interest: thus the private interest and public interest converge. However, cost cutting can also result in service quality degradation; the regulator thus must ensure that the buyer's capabilities to carry out public

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Department of Public Service, the Vermont PSB approved the transfer. Docket No. 7270, 2008 Vt. PUC LEXIS 40 (hereinafter, Vermont PSB FairPoint Approval Order).

interest obligations like universal service and emergency response remain strong. The buyer's private interests also largely coincide with the public's with regard to its desire to provide for the long-term viability of its business. However, private and public interests can diverge with respect to the particular investments required to maintain a healthy business, as well as their timing and their costs.

It is convenient to assume that the buyer's private interest will induce it to exercise reasonable business judgment in deciding to acquire the ILEC's wireline business. However, that assumption does not always square with the facts—particularly where the buyer is proposing to acquire portions of a much larger corporation with complex financial and operational interdependencies. In such cases, it is prudent to question whether the buyer's business experience is sufficient to ensure that it fully understands the nature and condition of the business it is acquiring and whether the buyer has exercised a level of due diligence that could help to compensate for the seller's relative advantages of information and business sophistication. While regulators might prefer not to second-guess a private business arrangement, in the case of a utility transfer, if the buyer is unable to make well-informed business judgments, the public will suffer the consequences.

III. Substantive Areas Requiring Regulatory Alertness

A. Is the regulatory authority sufficient?

Regulators in most states have general supervisory authority over incumbent local exchange telephone companies subject to their jurisdiction.[12] Most also have specific authority over transactions that transfer control of an ILEC's operations. In some states, the authority is set forth in broad terms, while in others there is a detailed template to direct the commission's findings.[13] Whether or not specific criteria are enumerated, the review is typically governed by a broad public interest standard.[14] The oversight can take various forms. Most states have statutes

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[12] See, e.g., 220 Ill. Comp. Stat. § 5/7-102 (2009) "Transactions requiring Commission approval"; 35-A M.R.S. § 1303 (2009) "Investigations" (giving the PUC the authority to investigate ""when it believes that …[a]n investigation of any matter relating to a public utility should for any reason be made."); Mass. Gen. Laws c. 159, § 12 "Services Subject to Jurisdiction" ("The department shall, so far as may be necessary for the purpose of carrying out the provisions of law relative thereto, have general supervision and regulation of, and jurisdiction and control over, the following services….").

[13] See, e.g., Mich. Comp. Laws § 460.6q (7) (2009), "Acquisition, control, or merger with jurisdictional regulated utility; approval of commission; notice and hearing; issuance of order; rules; filing comments; access to data and information; evaluation factors; terms and conditions; confidential information; definitions."

[14] See, e.g., Miss. Code Ann. § 77-3-23 (2008); HRS § 269-19 (2009). Even where the legislature has enacted a policy that affirmatively supports settlements in contested cases, the PUC remains that final arbiter and protector of the public interest. 26 Del. Code § 512 (2009).

requiring prior authorization by utility regulators for corporate reorganizations,[15] including mergers, that result in a transfer of control[16] or ownership of the utility; or for the sale or other transfer of a utility franchise.[17] Many states regulate both entry[18] of telecommunications companies and any discontinuation of service.[19] In fact, decisions that affect the financial stability of telephone companies may be subject to review even outside of a transfer of control or entry situation.[20]

Does the state's regulatory framework, as applied to this type of transaction, provide jurisdiction over the seller, the buyer, or both? In states where telephone companies are subject to entry and exit regulation, the regulator must approve both the transfer of control and the current incumbent's decision to discontinue providing service. In such cases, the regulator can approve the transaction without concurrently relieving the seller of its preexisting service obligations, in effect causing the seller to maintain an interest in assuring the successful outcome of the transfer. In the recent Verizon-FairPoint sale, for example, the Vermont PSB specifically held off granting Verizon formal authorization to abandon its service obligations until Verizon had fulfilled various conditions[21]and after the completion of a "successful cutover."[22]

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[15] See, e.g., 220 Ill. Comp. Stat. §5/7-204, "Reorganization defined; Commission approval therefore."

[16] Control can be direct or indirect. See, e.g., Ohio Rev. Code Ann. 4905.402 (2009) ("'Control' means the possession of the power to direct the management and policies of a domestic telephone company.")

[17] See, e.g., N.C. Gen. Stat. § 62-111 (2009); W. Va. Code *§ 24-2-12* (2009); D.C. Code § 34-1001 (2009); Hawaii Rev. Stat. § 269-19 (2009) (contains exception for emergency/exigent circumstances); but compare, Wis. Stat. § 196.805 (2008) (requires that telecom company provide the commission with "adequate notice of any consolidation").

[18] See, e.g.. Ky. Rev. Stat. Ann. § 278.020 (2009).

[19] See 220 Ill. Comp. Stat. § 5/8-508 (Abandonment or discontinuation of public utility service; hearing); NH Rev. Stat. Ann. § 374:28 (authorizing commission to permit a public utility to discontinue providing service on a permanent basis "whenever it appears that the public good does not require the further continuance of such service.").

[20] See Mass. Gen. Laws, c. 166, §§ 1-10 (Finances of Telephone and Telegraph Companies).

[21] For example, the Board required Verizon to set aside funds for FairPoint to remove "dual poles" (deemed Verizon's responsibility) and to cover 2008-2009 set asides for a fund for service quality assurance (deemed to reflect the current state of the telecommunications system and thus also Verizon's responsibility). Vermont PSB Approval Order at 58, *46.

[22] *Id.* at *75.

In some states, the legislature has imposed specific conditions on transfers of control that require the regulator to give priority to certain aspects of the transaction over others. In California, for example, the law governing transfers of control requires that the commission find that (a) the transfer will result in both short- and long-term economic benefits to ratepayers, and (b) the total short- and long-term forecasted economic benefits will be "equitably allocate[d]" between shareholders and ratepayers, with ratepayers receiving "not less than 50 percent of those benefits."[23] Of course, the sharing of benefits only comes into play once the commission has determined that the transfer will result in short- and long-term economic benefits, and based thereon, has authorized the transfer to take place.

B. Is the seller's role consistent with the public interest?

Proceedings to review a proposed transfer usually focus on the buyer's fitness to fulfill the public service obligations of an ILEC. There is also a need to scrutinize the seller's role in the transfer, because its decisions and actions affect the condition of the business that the buyer proposes to take over. The seller has superior knowledge of the business it is divesting.[24] It knows which services are most profitable and which are in decline. It also has the ability to make certain services appear more or less profitable, to the extent that it has discretion in allocating costs and revenues among several services. While in private negotiations, the seller might not have a duty to disclose information to the seller that would result in a lower sale price, it does have the obligation to satisfy the commission that the sales price represents a fair valuation of the business at the time of the transfer.

A portion of the value of an ILEC's wireline local exchange business derives from privileges it has obtained by virtue of its incumbency. As a large ILEC and, for many years, the monopoly provider of local exchange and intrastate long-distance services, Verizon had a reliable revenue stream from monopoly ratepayers to fund its ubiquitous distribution infrastructure. Verizon's public service obligations were also paired with many regulatory privileges that created value for the company, including access to public rights of ways, and, in some states, even eminent domain powers. Indeed, some state statutes affirmatively recognize and give effect to the public's stake in the ILECs' assets and the disposition thereof. This notion is reflected in the California statute, cited above, that *requires* that ratepayers share not less than 50 percent of the economic benefits of the transaction.[25]

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[23] Cal. Pub. Util. Code § 854.

[24] For example, in the pending Verizon-Frontier transaction, although Frontier approached Verizon, Verizon selected which exchanges to include in the sale as well as which customers to exclude.

[25] See also *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Transit Commission*, 485 F.2d 786, 810 (D.C. Cir. 1973), cert. denied, 415 U.S. 934 (1974) (Any gain on the sale or disposition of utility assets acquired with ratepayer funds should be given to ratepayers – establishing the principle of "reward follows risk and benefits follow burdens."). This court opinion, of course, does not necessarily bind anyone today, and there are state and federal commission decisions in disagreement.

A large, vertically integrated ILEC also obtains operating efficiencies by sharing facilities, human resources, and marketing channels among various lines of business. The manner in which the ILEC structures a divestiture affects how much of the value associated with these efficiencies conveys with the divested business and how much the ILEC retains for the benefit of business segments not being transferred. For example, the pending sale to Frontier does not include all of Verizon's wireline assets in the affected service territories. Verizon has excluded some 3500 large business customers, plus the federal government and service provided by one of Verizon's affiliates to customers in multi-unit dwellings.[26] Regulators should require the seller to explain in detail which assets located within the geographic footprint of the transfer are excluded and to explain all cost allocation and revenue impacts related to the exclusion.

The ILEC retains all of its public service obligations up until the point at which it is specifically relieved of them by the regulator, when the regulator approves the transfer of control and (if separately required by law) authorizes the ILEC to discontinue providing service. If the selller falls short of its obligations before it obtains these authorizations, that shortfall will have a negative impact on the buyer's ability to fulfill its public service obligations at the time it steps into the seller's shoes. The resulting additional burden to the buyer could take several forms, including increasing the buyer's costs, adding complexity to the operational transition, or requiring immediate attention to service quality issues—or all three.

C. Is the buyer capable of meeting its new public service obligations?

1. Risks related to potential overexpansion

In many past telecom mergers or purchases of exchange assets, the acquiring party was comparable in size to or larger than the acquired entity in terms of assets, customers, employees, revenues, or other attributes of overall scale and scope. The recent and pending transactions in which large ILECs are attempting to divest large blocks of wireline operations to much smaller carriers do not conform to this pattern. Such an expansion in the buyer's business introduces complexity into management and operational activities, and can be a source of financial stress.

The pending Frontier transaction would triple the number of access lines under Frontier's management and triple the size of its workforce.[27] It would require Frontier to operate multiple unfamiliar billing and other operations support systems. As the prospectus discloses,

> the acquisition of the Spinco business is the largest and most significant acquisition Frontier has undertaken. Frontier management will be required to devote a significant amount of time and attention to the process of integrating the operations of Frontier's business and the Spinco business, which may decrease the

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[26] Frontier Communications Corporation Form S-4 Registration Statement filed with the Securities and Exchange Commission, July 24, 2009 ("Frontier-Verizon S-4") at A-2-10.

[27] Frontier's current active workforce consists of 5,650, employees, while the pro forma combined company would employ 16,000. Frontier-Verizon S-4. Frontier's access lines would increase from 2.2 million to 7 million.

> time they will have to serve existing customers, attract new customers and develop new services or strategies…. The size and complexity of the Spinco business and the process of using Frontier's existing common support functions and systems to manage the Spinco business after the merger, if not managed successfully by Frontier management, may result in interruptions of the business activities of the combined company that could have a material adverse effect on the combined company's business, financial condition and results of operations.[28]

Table 3 below shows the initial size of ILEC buyers in recent telecommunications industry exchange sales (including mergers), compared with the size of their acquisitions. Access lines, a readily available metric, are used as an indicator of firm size. The table compares three sales in which the successor ILEC has remained financially viable and operationally stable for a decade following the transaction with two in which the buyer has struggled financially and operationally within a short time of completing the transaction. The data show a better track record in sales where the assets being purchased are not so much greater than the purchaser's original business. We acknowledge that size alone does not fully predict whether a transfer will serve the public interest. It does, however, raise a red flag that greater vigilance is required to ensure that the new ILEC has made sufficient preparations for the expanded managerial, technical, and financial demands it will experience.

[28] Frontier-Verizon S-4 at 24.

Table 3
Comparison of Relative Sizes of Buyers and Sellers in Selected Telecom Mergers and Acquisitions
Access Lines in Millions

	Buyer remained financially stable			Buyer in bankruptcy		????
Verizon Acquisition of GTE Companies	**Bell Atlantic Acquisition of GTE Companies (1)**	**SBC Acquisition of Ameritech Companies (2)**	**Qwest Sale of Exchanges to Citizens (2000) (3)**	**Verizon Sale of GTE-Hawii to Carlyle Group (2005) (4)**	**FairPoint Acquisition of Verizon ME, NH, and VT (March 2008) (5)**	**Frontier Acquisition of Selected Verizon GTE Exchanges**
Pre-Merger Acquiring Company	41.6	34.0	1.40	0.00	0.3	2.3
Pre-Merger Parent of Exchanges being Sold	26.0	20.8	18.00	49.30	46.0	43.4
Exchanges Being Acquired	26.0	20.8	0.017	0.700	1.5	4.7
Post-Merger Entity	67.6	54.8	1.42	0.7	1.8	7.0
Ratio of Total Seller Access Lines to Lines Sold	1.00	1.00	0.00	0.01	0.03	0.11
Ratio of Acquired Lines to Total Buyer Lines	0.6	0.6	0.0	n/a	4.9	2.0
% Buyer Access Lines Increased	63%	61%	1.2%	n/a	487%	204%

Sources:
(1) Annual Reports of GTE Corporation (1999) and Bell Atlantic Corporation (1998). Both available on Verizon website www.verizon.com.
(2) *SBC to acquire Ameritech,* Network World, August, 1998. Available at www.networkworld.com.
'02.
(4) Verizon 3rd Quarter 2006 Earnings Report. Available on Verizon Webstite www.verizon.com and FCC Trends in Telephone Servce, Feb '07
(5) Annual Report, Verizon (2008). Available on Verizon website www.verizon.com.

As the table demonstrates, in the three merger/acquisitions identified as "Buyer remained financially stable," the ratio of lines acquired to lines provisioned by the purchasing entity is less than one. In the case of both the original acquisition of the GTE exchanges by Bell Atlantic in 2000 (creating Verizon) and the later SBC acquisition of the Ameritech companies, the number of lines served by the post-merger firm was approximately 60% greater than pre-merger. The 2000 sale of Qwest exchanges (a total of 17,000 access lines) to Citizens (which operated less than 2 million lines pre-acquisition) represented an increase of approximately 10%. Conversely, Verizon's sale of 1.5 million access lines to FairPoint, which increased that company to five times its original size, and the Verizon sale of the 700,000 lines of the former GTE Hawaii (to a private equity group) both resulted in bankruptcy. With the addition of the 4.8 million Verizon access lines across fourteen states that Frontier proposes to purchase, the new expanded Frontier would have three times as many access lines as the pre-acquisition Frontier. While regulators cannot assume that the Verizon-Frontier transfer will take the same path as the Verizon-FairPoint sale, it would make sense for them to intensify their scrutiny of any areas where the buyer's rapid expansion could jeopardize its operational or financial stability. To overcome these concerns, the buyer must be prepared to offer concrete plans to accomplish a smooth operational transition and long-term financial stability, as well as contingency plans. The buyer might also strengthen its case by offering sensitivity analyses on all critical assumptions, so that the regulator can evaluate the likelihood that the buyer will accomplish the requisite public interest objectives under unpredictable real-world conditions.

2. Financial

As discussed in Part II above, ensuring the financial stability of the prudent ILEC serves customers' interests as well as those of the utility's owners and creditors. The fate of competition also is at stake. The ILEC controls essential facilities for accessing the public switched telephone network (PSTN). The ILEC's viability and reliability therefore affect not only its own retail customers but also various other telecommunications providers, including such "intermodal" competitors as wireless whose operations would not be possible without access to and use of ILEC facilities. The financial stability of the ILEC also affects rate stability. An ILEC perceived as well managed and financially sound can borrow at a lower rate than one perceived to be risky. Higher debt and equity costs can lead to higher rates. If the ILEC is unable to increase rates, there is a risk that it will cut costs in a way that diminishes service quality to unacceptable levels.

In reviewing the buyer's financial qualifications, the regulator should not rely upon a financial snapshot taken at the time of the hearing. Rather, the regulator must evaluate the buyer's likely financial performance over its tenure as the dominant ILEC—as far into the future as it is reasonably possible to make such an evaluation. At the time that the buyer enters into the agreement, it has one financial profile. As soon as it completes the deal, its financial profile changes. The FairPoint purchase in 2008, like the pending Frontier purchase, transformed the buyer into a much larger company, with far more debt and many new shareholders. If the buyer has to make remedial or transition-related investments in its acquisition (because, for example, it needs to upgrade facilities neglected by the seller or install new operations support systems), or if it has committed to make large investments in new technology (e.g., broadband), it will need more financing. All foreseeable likely financial impacts resulting from the decision to expand are pertinent to the assessment of the buyer's post-transaction financial condition. We will look now at four possible contributors to post-transaction financial difficulties: problems related to overpaying for the acquisition, risk of overly optimistic financial projections, the relative financial strength of business and assets before and after the transaction, and transition costs.

a. Problems related to overpaying for the acquisition

If the buyer pays too much—i.e., more than the economic value—for the business it is acquiring, it will have trouble generating the revenue to sustain the business. In evaluating the deal, the regulator must thus determine whether the assets and operations subject to the sale are properly priced. The regulator cannot assume a proper price simply from an arm's-length business transaction. U.S. corporations routinely engage in mergers and acquisitions that, in hindsight, were not good deals. Telephone companies are no exception.[29] Of course, many mergers and acquisitions are successful; however, there is no assurance, *a priori*, that any given transaction will have this outcome. If the very largest of the nation's phone companies can err about the value of other telecommunications assets they are purchasing, there is risk that smaller, less sophisticated purchasers can make the same mistake. Moreover, the potential harm to the buyer from overpaying is greater when the acquisition represents a large portion of the company's overall assets than when the inflated assets represent only a small increment of the company's total size. This is another reason why the purchase by a small ILEC of a much larger business poses particular financial risks.

In the case of a rate-regulated ILEC or other public utility, any proposed sale of assets at a price above net book value requires skepticism. Under rate-of-return regulation, the firm's profit is based on its net book value. While going business assets are frequently sold at a premium, it is because of reasonable expectations that the assets can generate profits commensurate with the premium price. Multi-state wireline telephone exchange sales do not occur on the open market on a regular enough basis for there to be a clear "market price." However, information about industry trends—including recent pronouncements by Verizon—expose risks for the future of wireline telecommunications business. Since 2000, the large ILECs have reported a 20% decrease in wireline access lines.[30] By transferring assets for which utilization (and the associated revenues) has dropped (and where the decline is likely to continue), the seller has an opportunity to shed stranded investment. A case could be made that the wireline exchange assets should be selling for less than net book cost because, in the face of persistently declining demand, there is no assurance that the buyer can achieve a level of revenue sufficient to recover even its book costs, let alone anything beyond that. Under these circumstances, the buyer would need to provide compelling evidence to justify paying book value or above, such as concrete and realistic plans for reversing the multi-year trend of declining demand for wireline telecommunications services or another innovative solution that would generate revenues in a manner consistent with the public interest.[31]

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[29] For example, the old (i.e., pre-SBC) AT&T Corp. overpaid by tens of billions of dollars for the cable TV assets of TCI and MediaOne, notwithstanding the fact that both acquisitions involved arm's-length transactions. (See "Dead man walking—AT&T has mismanaged its cable systems from the start. Now suitors are circling. Will Wall Street buy Ma Bell's problem child?" *Fortune Magazine*, July 9, 2001). Before that, in 1993 AT&T Corp acquired NCR for $7.5 billion and five years later sold it for a little over fifty cents on the dollar for only $4 billion. *See* "AT&T-NCR Merger Offers a Reminder: Many Big Deals Turn Out to Be Dogs," *The Washington Post*, November 2, 1993 and http://www.fundinguniverse.com /company-histories/NCR-Corporations-Company-History.html.

[30] FCC Local Competition Report, as of June 30, 2008, Table 1.

[31] An alternative explanation for a buyer's willingness to pay a premium over book cost for rate-regulated ILEC assets in the face of steadily declining demand could be the buyer's expectation that it will be successful in leveraging its position as the dominant incumbent LEC to extract supracompetitive profits from its customer base, either through a succession of rate

Absent the introduction of efficiencies and cost savings or stimulated revenue opportunities from the same plant, commensurate with the premium paid, the purchaser of above-net-book-cost assets will be less profitable with those assets than the seller. Table 4 below illustrates the impact that paying a premium above net book value can have upon the cost structure of a purchaser. As the table demonstrates, all else being equal (operating expenses, depreciation and taxes, revenue streams) and assuming (for illustrative purposes) a return on the net investment goal of 11% and cost of capital of 5%, payment of a 20% premium over net book value for exchange assets would result in an increase in the annual revenue requirement associated with return and interest expense of almost 30%. The example below shows that if a purchaser pays a 20% premium for a single access line with a net book value of $100, it would need to either reduce costs or increase rates by a total of $3.20 per year or a little over twenty-five cents per month to support its investment.

Table 4
Illustration of Potential Additional Revenue Requirements Flowing from a Sale of Exchange Assets at an Above-Cost Price

	Seller's illustrative pre-sale cost	Buyer's illustrative post-sale cost	Buyer's illustrative additional cost
a) Assumed Net Book Value of Exchange Asset Being Acquired	$100.00	$100.00	N/A
b) 20% "Premium" Sale Price Above Net Book Value	N/A	$20.00	N/A
c) Total Asset Value on Books (a + b)	$100.00	$120.00	20%
d) Annual Return on Asset (assuming 11%) (c * 11%)	$11.00	$13.20	20%
e) Annual Capital Expense related to financing 'Premium' (Assuming capital cost of 5%) (b * 5%)	N/A	$1.00	N/A
f) Annual Return and financing expense (c + e)	$11.00	$14.20	29%

To understand whether the exchange asset facilities are properly priced, there also needs to be an analysis of the current profitability of the services in the hands of the incumbent seller. If the assets are associated with the provision of services that have been profitable for the seller and are showing the potential for increasing volumes or revenue streams, the buyer would have a rational reason for paying a premium. Conversely, if the services provided over the exchange facilities are only marginally profitable, or the prognosis includes a reduction in revenue potential (for example, due to ongoing access line losses), a premium is likely not warranted—and in fact a discount deserves consideration.

increases and/or through horizontal expansion into adjacent nonregulated services such as broadband.

b. Risk of overoptimistic financial projections

When the buyer presents its financial projections showing an expectation of profitability and stability in the post-acquisition years, it makes certain assumptions about costs and revenues. Since the future of the business depends on the quality of these assumptions, the regulator must validate them. On the cost side, when the buyer has only limited knowledge of the condition of the business it is acquiring, it will likely encounter major unanticipated expenses. If it is overconfident about its chances of transforming a declining business, it will overestimate revenues and underestimate costs.

There were instances of overoptimistic assumptions that gave regulators pause in their review of the Verizon-FairPoint transfer. Regulators rejected some of these assumptions,[32] and tempered others by subjecting them to sensitivity analyses.[33] As in other areas of the financial analysis, where the costs and revenues resulting from the business expansion larger than the size of the original business, the buyer's financial health is sensitive to faulty cost or revenue predictions.

c. Relative financial strength of business and assets before and after transfer

In addition to looking at the current financial condition of the buyer, the commission needs to understand the effect of ownership change on the business's finances. The regulator should compare the buyer's and seller's financial structures, since these will directly affect the costs of raising capital. The seller's actual and projected costs and revenues for the business can help to assess the reasonableness of the buyer's projected costs and revenues. Investments that the seller could afford to make because of its superior financial condition are less likely if the buyer is struggling under new debt. Without making a direct comparison, however, the financial claims of the buyer are hard to put in perspective.

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[32] Vermont PSB Approval Order at *23.

[33] Vermont PSB Rejection Order at 49, 65.

Table 5 Analysis of Debt Load Pre- and Post-Acquisition			
	Frontier	**SPINCO (Verizon Assets)**	**Post-Acquisition Frontier**
(a) Access Lines	2.25 million	4.80 million	7.05 million
(b) Net Debt	$4.5 billion	$3.5 billion	$8.0 billion
(c) EBITDA	$1.2 billion	$1.9 billion	$3.1 billion
Net Leverage: (c) / (b)	3.8x	1.9x	2.6x
Net Debt per access line (b) / (a)	$2,000	$737	$1,143
Note: Data pro forma for the year ended December 31, 2008, except as noted. **SOURCE**: "Welcome to the New Frontier" Slide Presentation dated May 13, 2009 available at the Frontier Communications Website, Investor Relations page, http://phx.corporate-ir.net/phoenix.zhtml?c=66508&p=irol-irhome			

The value of a "before and after" view of financial data can be illustrated by examining Frontier's claim that its acquisition of Verizon's lines would be financially beneficial because it was "deleveraging." What Frontier meant by this statement is that Frontier's average debt per access line would be lower after the acquisition ($1,143) than before ($2,000).[34] But this description of the change has the wrong focus. Verizon is carrying the 5 million lines Frontier proposes to acquire at a much lower average debt per line ($743). This means that Verizon (and the customers it serves) are at lower financial risk if the wireline business continues to decline (as Verizon has projected) than if the same lines are being operated by a company that carries 50 percent more average debt per line. The addition of Verizon's lines does not erase Frontier's debt load on its existing lines; instead, Frontier must increase its debt overall to pay Verizon for the purchase and to support maintenance and improvements on the additional 5 million lines. While the acquisition would reduce Frontier's average (company-wide) debt per access line, the total debt for the company would grow from $4.5 to $8 billion.[35] And by spreading Frontier's average debt load across all of its post-acquisition access lines, the lines acquired from Verizon

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[34] See Table 5 for the derivation of the figures used in this portion of the discussion.

[35] "Welcome to the New Frontier" slide presentation, dated May 13, 2009. Frontier Communications Website, Investor Relations page.

will actually sustain an *increase* in their debt load—going from $750 (under Verizon) to $1,150 (under Frontier). Thus, even if the transaction is "deleveraging" for Frontier as a whole, it increases the leverage associated with the exchanges being acquired.

d. Transition costs

The legal and regulatory processes required to accomplish the transfer of control are costly to both buyer and seller. The parties' agreement apportions these costs between them. The transition also imposes discrete, non-recurring costs that the buyer must absorb on top of normal operating expenses. Regulators normally treat the costs associated with the sale transaction and the subsequent transition costs as the sole responsibility of management and shareholders, and have rejected recovery from ratepayers.[36] (The exception to this treatment arises when there are specific, positive benefits to be allocated, in part, to ratepayers; in such cases, the ratepayers' share may be offset by a comparable share of merger implementation costs so that there is symmetry of cost and benefit.) However, the fact that these costs are not recovered in rates does not negate their financial impact upon the post-transaction buyer. As such, regulators need to evaluate the financial impact on the buyer of absorbing these one-time transactional expenses.

3. Managerial

The assessment of the buyer's managerial qualifications involves judgment and prediction. That the buyer comes from the same industry does not mean that it can integrate effectively a business that is many times its existing size. FairPoint already offered local and long distance telecommunications services in 18 states at the time it purchased Verizon's exchanges in northern New England.[37] That management experience did not suffice when it encountered a broad range of operational, service quality, and financial problems. Frontier, which now seeks to operate Verizon's wireline business in fourteen states, has also been an ILEC for many years.[38] As support for its proposed acquisition, Frontier cites its past acquisitions,

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[36] See, e.g., Vermont PSB Rejection Order at 95-96.

[37] The Vermont PSB notes that FairPoint's management structure is "typical" and that it reflects FairPoint's experience as a rural provider. "This knowledge was acquired on a much smaller scale than the network size associated with this acquisition." Vermont Rejection Order at 32.

[38] What is now known as Frontier Communications Corporation was operating, up until 2008, under the Citizens Communications Company name. Citizens grew through a series of ILEC acquisitions, including 320,000 ILEC and 100,000 CLEC lines from Commonwealth Telephone Company (Pennsylvania) and 12,000 lines from Global Valley (California) in 2007; 1.1 million lines from Global Crossing in 2001; and 750,000 lines from the former GTE between 1993 and 2000. Global Crossing had in 1999 previously acquired the former Rochester Telephone Company (then also known as Frontier). Rochester Telephone had entered the long-distance business in 1984 and the wireless business in 1985. In 1988, it acquired 29 small independent ILECs, and in 1995 changed its name to Frontier. That Frontier company was purchased in 1999 by Global Crossing. When Global Crossing sold its ILEC business to

including other GTE assets.[39] There are important differences, however, between those additions and the pending purchase. Frontier's prior acquisitions of GTE exchanges occurred over a seven-year period, and the largest single prior addition of GTE exchanges involved 300,000 lines (compared to the 4.8 million involved in the current deal).[40] Managerial experience successfully operating a small firm in a given line of business does not always translate into comparable success where the firm's size increases—especially when that increase in scale is sudden rather than gradual.

In general, the testimony attesting to the buyer's managerial qualifications comes from its own managers.[41] The buyer may also produce testimonials from other sources,[42] but the regulator will have to rely upon staff, interveners, and independent inquiry for more critical assessments. The broad generalizations about education and prior employment contained in typical prefiled testimony are not as helpful as responses to questions about how management intends to approach specific business challenges, including the management of the transition in operations, customer accounts, and personnel matters. The description of the post-acquisition management put forward by the buyer tends to be predictive and not verifiable. It is essential, therefore, that regulators verify these descriptions of post-acquisition management, so as to distinguish them from aspirations and hopes. Since the additional managers and management structures that the buyer will require after expanding will likely not be hired and deployed until after the transaction closes, regulators should insist that evidence as to managerial qualifications be directed toward post-acquisition plans and structure, not to pre-acquisition history.

Citizens, it also sold Citizens the Frontier name. Citizens managed these properties under that name until 2008, when it reverted to the Frontier name—the name under which it currently operates.

[39] Frontier Communications Corporation, Verizon Communications, Inc., et al., Joint Application for the approval of a Reorganization pursuant to Section 7-204 of the Public Utilities Act, Illinois Commerce Commission Docket No. 09-0268, Direct Testimony of Daniel McCarthy, Frontier Executive Vice President and Chief Operating Officer (Joint Applicants' Exh. 1), at 18-19 ("Frontier has a highly 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.")

[40] *Id.* at 19.

[41] For example, in its direct case, Frontier offered only one witness—its Executive Vice President and Chief Operating Officer—in support of its application to acquire roughly 600,000 access lines from Verizon in Illinois and to attest to the qualifications and experience of its senior management team. Ill. C. C. Docket no. 09-0268, Frontier Ex. 1, at 4-5.

[42] See, e.g., Vermont PSB Rejection Order at 31-32 (investment community assessments).

Specific questions about how the buyer intends to identify and recruit qualified managers and about its experience in this regard may help the regulator to develop a clearer picture of the buyer's management credentials.

- **Which of the existing (seller) management will be retained by the buyer?**
- **What are the specific details of the proposed management structure?**
- **What financial incentives will be offered to existing (seller) management to remain with the buyer after the acquisition closes?**
- **How will management be divided up among functional areas—basic regulated wireline services, wholesale services, and nonregulated competitive services?**
- **Will any jobs currently being performed within the jurisdiction be transferred out of state or offshore? If so, which ones?**
- **Are there any specific areas where the buyer expects to improve over legacy management? Where will such improvements be directed, and on what specific basis does the buyer believe that it will be capable of out-performing the seller?**
- **How does the buyer plan to integrate new employees into its existing workforce? What specific plans does the buyer have for addressing disparities in pay, benefits, work rules, union relationships, and workplace culture?**

There also needs to be an examination of management's competency and foresight about specific, critical operational challenges by asking questions such as:

- **How will legacy operational support (OSS) and information technology (IT) systems be supported, expanded and, perhaps, ultimately migrated to the acquiring company's systems?**
- **How will functions that are or will be performed outside of the state jurisdiction be provided—for example, customer care, billing, repairs, and maintenance?**

If the incumbent's management has failed to maintain a responsive regulatory presence or been unresponsive to commission mandates, the regulator should evaluate what specific conditions will prevent these same problems from arising again under new management.

4. Operational and technical

Regardless of whether the regulatory agency is persuaded that the buyer has the requisite capabilities to operate the telecommunications franchise in the long term, it must separately and distinctly evaluate whether the buyer can effect a smooth transition of the business from its former owner. The event during which the transition from one provider to another occurs is often referred to as the "cutover."[43] As the experience in the recent Verizon-FairPoint sale shows,[44] there is risk of service disruption during the transition.

One area of vulnerability is the process of transitioning the functionality of computerized systems that provide ordering, billing, and other ongoing operational functions (e.g., repair) for wholesale and retail customers. In taking over Verizon's wireline operations in Vermont, New Hampshire, and Maine, FairPoint chose to replace Verizon's existing operation support systems (consisting of five major business systems) to new systems with "state-of-the art next generation applications" that, according to FairPoint, would better fit the business model FairPoint intended to adopt.[45] The transition to these new systems did not go smoothly, however. There were repeated delays in the cutover of the new systems. As of early November 2009, 19 months after the transfer and 9 months after transitioning off of Verizon's operations support systems, service quality has yet to be restored to pre-merger levels.[46]

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[43] The coordination and planning for such a transition is complicated and resource-intensive. For example, the project plan prepared for the business and systems integration and cut-over from Verizon to FairPoint systems and operations contained over 8,000 task items, yet was nonetheless criticized for lacking sufficient detail. Vermont Order at para. 511 (among other things, "many of the project areas will require additional detail to validate estimates and for execution.")

[44] See, e.g., "FairPoint besieged by complaints," *Maine Sunday Telegram*, 3/22/2009 (accessed at http://morningsentinel.mainetoday.com/news/local/6099988.html) ("'I'm getting more customer complaints about FairPoint than I've gotten on any utility,' said Wayne Jortner, senior counsel for the Office of Public Advocate"); "FairPoint repair complaints prompt PUC questions," *Lewiston Sun-Journal*, 9/15/2009 (accessed at http://www.sunjournal.com/node/276118/)

[45] Vermont PSB Rejection Order at 171.

[46] In a letter dated October 20, 2009, [www.governor.nh.gov/news/2009/102009.html], the governors of Maine, New Hampshire, and Vermont wrote to FairPoint's CEO David Hauser, "As you are well aware, FairPoint customers in Vermont, New Hampshire and Maine have, over the past year, withstood serious service quality problems as a result of the conversion from the Verizon systems to your own. FairPoint's ongoing and persistent operational problems continue to be a source of inconvenience and hardship for FairPoint customers in Northern New England." See also, Petition of the Department of Public Service for an Investigation and for an Order Directing Telephone Operating Company of Vermont LLC, d/b/a FairPoint Communications, to Show Cause Why its Certificate of Public Good Should Not be Revoked, July 14, 2009, Vermont PSB Docket 7540.

In the pending proceedings on the Verizon-Frontier sale, the parties have emphasized that the transition will be handled differently from the FairPoint migration.[47] Applicants made similar statements in the Verizon-FairPoint testimony concerning how their transition would differ from the earlier unsuccessful cutover after Verizon's sale of its wireline operations in Hawaii.[48] Regulators should look past these assertions and probe for facts.

The testimony filed by applicants in the recent and pending transfer cases offers general assurances that appropriate measures are being taken to ensure a smooth transition. It is important for regulators to examine the details that back up these assurances. The legal documents governing the sale specify the seller's obligations to assist the buyer with transitioning various aspects of the business. In the recent exchange sale in northern New England, the terms of the sale as approved by regulators permitted Verizon to withdraw its operational support to FairPoint as soon as the cutover to FairPoint's new systems occurred. Since (at least as proposed) much of the transition will continue after the seller's involvement has ended, regulators should insist on detailed plans for how the buyer intends to manage all aspects of the transition, and contingency plans for dealing with less-than-best-case scenarios.

In the recent exchange sale in northern New England, the terms of the sale as approved by regulators permitted Verizon to withdraw its operational support to FairPoint as soon as the operational cutover occurred, leaving FairPoint to rely on an independent firm that had developed the replacement operations support systems for the ongoing transitional support.[49] Concerns over the experience of the consultant led regulators in the three affected states to require monitoring of the transition by a separate consultant, which added to the costs of the transaction.[50] In the pending Frontier transfer, Frontier plans not to develop new operations support systems but, rather, to take over the existing Verizon/GTE systems. Whatever the source, ongoing support can be a large expense for the buyer.[51]

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[47] See, e.g., Direct Testimony of Daniel J. McCarthy, Frontier Communications, at 29, Illinois Commerce Commission Docket No. 09-0268.

[48] Rebuttal Testimony of Stephen E. Smith on behalf of Verizon New England Inc. et al., Joint Application for Approvals Related to Verizon's Transfer of Property and Customer Relations to Company to be Merged with and into FairPoint Communications, Inc., Maine Public Utilities Commission Docket 2007-67, at 13.

[49] Vermont PSB Approval Order at *75.

[50] The Vermont PSB initially proposed that the cost of monitoring the operational transition be split between seller and buyer; however, the settlement it subsequently approved put the full financial burden on FairPoint. See, Vermont PSB Approval Order at ***63-***64.

[51] For example, the prospectus discloses that Frontier would pay Verizon an annual fee of $94 million for performing certain ongoing software maintenance and support. Verizon-Frontier S-4 at 107.

D. Buyer commitments regarding future investments

In the recent Verizon-FairPoint transfers, one reason that regulators gave for favoring the transfer of control was Verizon's unwillingness to deploy broadband and the perception that there was nothing that could compel it to do so.[52] FairPoint claimed that it would remedy this condition. Frontier has made similar promises. If broadband deployment has public benefits that weigh in favor of transferring control to the new ILEC, it is obviously important for the regulator to have the means—both legal and practical—to compel the new ILEC to fulfill its promise. In their orders approving the FairPoint transaction, regulators included mechanisms for monitoring broadband deployment and financial penalties in the event of non-compliance. However, penalties cannot cause compliance if the provider is financially unable to comply. The regulator must determine, therefore, not only what conditions are necessary to warrant approval, but whether the new incumbent will have the financial ability to absorb penalties for noncompliance.

E. Regulatory oversight of buyer

When a small ILEC steps into the shoes of a larger one, its regulatory status can change. In some states, large ILECs and smaller ones are subject to different forms of regulation. One way that the buyer might seek to allay the regulator's concerns about loss of rate stability and other regulatory constraints that apply to the seller's ILEC business is to agree to become subject to the regulatory regime currently applicable to the seller. This approach is particularly a problem when the alternative form of regulation, such as price caps, rate stability, or some other form of incentive regulation, applied to the previous incumbent (i.e., the seller in the pending transfer transaction) in exchange for specific commitments that do not necessarily apply to the buyer. To the extent that the buyer is unfamiliar with the regulatory regime it is adopting, it might make incorrect assumptions about its ability to maintain the rate path established by its predecessor or about the revenues that its new business will generate. Any regulatory approval of the transfer transaction should make clear to the buyer precisely what regulatory conditions will apply to its post-acquisition operations. The buyer should provide the regulator with a detailed *pro forma* financial analysis of its operations pursuant to that regulatory regime, reflecting the costs associated with all conditions.

F. Buyer's and seller's track record in prior transactions

The buyer's and seller's representations about their intentions in the present transaction are harder to verify than their actual actions in other similar transactions in the past. Thus, when information about other similar transactions is available, it can help the regulator to identify potential areas of concern. The way that rural ILECs such as FairPoint and Frontier have

[52] See, e.g., Verizon New England, Inc. et al. and FairPoint Communications, Inc., Petition for Authority to Transfer Assets and Franchise, Order Approving Settlement Agreement with Conditions, 2008 NH PUC LEXIS 8, ***133-***134 (2008); Vermont PSB Approval Order at ***5-***6. To the extent that regulators consider the lack of broadband deployment by the current ILEC to harm the public interest, a possible alternative would be for the regulator to seek legislative changes at the state or federal level (as applicable) that would give it authority to compel system upgrades that include broadband capabilities.

expanded is through gradual acquisitions of other small ILECs. However, as noted previously, the financial, managerial, and operational resources needed to grow by small increments over an extended time are different from what is necessary to absorb a geographically dispersed operation that is two or three times the size of the buyer's existing business. For this reason, successful outcomes in these prior purchases are not conclusive evidence of the buyer's ability to be successful in much larger purchases.

In the decade following the 1996 Telecommunications Act, large ILECs were primarily in expansion mode. However, since 2005, when Verizon completed its merger with MCI and SBC acquired AT&T, there have been more sales of selective business units. Verizon, in particular, has been particularly active in selling off parts of its business in recent years, completing "at least 18 transactions in the past seven years" according to a recent *Wall Street Journal* article.[53] The fact that three of Verizon's recent divestitures have ended in bankruptcy, including, most recently, that of FairPoint on October 24, 2009, has caused some to ask whether the terms of the sales have contributed to their failure.[54]

One can argue about whether the operational problems arising from the Hawaii and New England Verizon transactions were caused by overaggressive structuring of these transactions on the part of Verizon or by the inexperience of Carlyle and FairPoint in managing large-scale, state-wide ILECs. However, with respect to another one of Verizon's recent transactions that also ended in bankruptcy, valued at around $3 billion, Verizon was actually operating on both sides of the transactions, i.e., as seller and as buyer. When Verizon spun off its IDEARC directory business spin-off, the new company started out with a less-than-sound financial

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[53] "The Two Sides of Verizon's Deal Making" by Dennis K. Berman, *The Wall Street Journal*, August 11, 2009.

[54] *Id.* Here is Mr. Berman's assessment of Verizon's recent sales of telecommunications businesses:

> Verizon's former yellow-pages unit, which goes by the ungainly name of Idearc, sought court refuge from creditors in May; Verizon's former Hawaiian telecom franchise, purchased by Carlyle Group, filed for bankruptcy in December, and FairPoint Communications, which absorbed landlines from Verizon in a complicated divestment, is close to going under, the company said in a July securities filing. In all, these companies have lost upward of $13 billion in value and counting. This should make Mr. Seidenberg a hero to Verizon investors. Not only did he bail out of the assets at the right moment, he extracted prices that literally sucked the life out of the buyers. If only it were that simple. In the case of Idearc and FairPoint, their buyers happened to include Verizon shareholders themselves. They received controlling interests in the newly formed companies. That is a good thing for those who sold out early. Those who didn't are now sitting on Idearc and FairPoint stock trading at three cents and 54 cents a share, down from around $28 and $10, respectively, when the spinoffs began.

foundation (in fact, it carried excessive debt).[55] While FairPoint and IDEARC's shares lost 97% and 99% of their value, respectively, during the same periods, Verizon's own shares dropped by a mere 13%.[56]

IV. Procedural Tools for an Effective Investigation

To ensure regulatory access to the necessary substantive and relevant information, regulators should require applicants' initial filings to answer specific questions about public interest concerns. The Appendix poses these questions, in a form that regulators can adapt in their states.[57] Concurrent with the initial application, the regulator should also obtain all public documents related to the transfer, including the commercial agreement and any related contracts (however specified), along with any FCC application, SEC filings, Department of Justice, and investor and investment analyst communications.[58] The Appendix also identifies these documents. Certain materials require *in camera* treatment; the regulator can develop appropriate protective orders and procedures as part of the filing requirements template.

Requiring the necessary information in the initial filing is particularly useful for any state commission required by law to complete its review within a specified time. It places the information-gathering responsibility where it belongs, and gives notice of this information's importance before any clock starts to run.[59] A clear directive regarding the burden of proof also increases the likelihood that the parties will present a comprehensive affirmative case.

This point warrants emphasis. Typically, the applicants have the burden of demonstrating that the proposed transfer meets the statutory criteria for approval. The precise manner in which the burdens of proof and going forward apply in any particular state depends on the wording of the authorizing statute, as interpreted by the state courts. Some applicants have argued for shifting this burden, suggesting that the proposed transfer must be approved unless the regulator or another party produces evidence that the transfer would harm the public interest. Regulators who inadvertently accept this approach, if it is not compelled by statute, are more

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[55] Dennis K. Berman, "The Two Sides of Verizon's Deal Making," *The Wall Street Journal*, August 11, 2009.

[56] *Id.*

[57] The development of a testimony production template could also facilitate investigations in transfer-of-control cases involving other regulated utilities.

[58] In preparation of these documents, the applicants address specific concerns that arise under the respective agencies' legal review. Taken together, they provide varied perspectives and additional data that the seller and buyer might not otherwise file in support of their state application.

[59] It also should work to the benefit of the applicants, whose private interests benefit when they are able to complete their transaction expeditiously.

likely to conclude that they must approve the transaction. Then they identify and prescribe conditions that they hope will fix deficiencies in the transfer. There is a better approach: If there is certainty about the deficiencies but doubt about the efficacy of the conditions, the better course is to reject the transaction. A clear understanding of the burdens of proof will help commissions sort through these issues.

Acquiring much of the required information at the outset allows the regulator and parties to use their discovery opportunities more efficiently to develop more detail and insight about the transaction. Oral depositions and an accelerated schedule for receiving and addressing objections can streamline this process. The records from prior similar transactions and proceedings in other states are a good place to start for developing interrogatories. Orders from other states in which similar matters have been reviewed can alert the regulator to important issue areas that might otherwise be overlooked. With the ability to anticipate evidentiary gaps, the regulator is better able to provide guidance to ensure that there is a record that supports a well-informed decision.

V. Options for Addressing Public Interest Concerns

On receiving a transfer application, the regulatory agency can take one of three specific actions:

- Approve the transaction as outlined by the applicants;
- Deny the application as outlined by the applicants; or
- Conditionally approve the application, subject to the parties' acceptance of specific requirements as specified by the agency.

A. Approval with conditions

In both the large ILEC mergers that occurred in the years following the 1996 Telecommunications Act and in the recent acquisitions by smaller ILECs discussed in this paper, regulators have opted most frequently for conditional approval. This is an appropriate response when there are specific areas of concern that can be identified and addressed with targeted remedial provisions. Where potential problems are pervasive or not remediable by specific actions within the applicant's control and ability, conditional approval cannot lead to a transfer of control that is in the public interest.

Any condition must provide a remedy to a specifically identified defect, and must remain in place so long as the problem persists. Failure to observe this guideline has been a particular shortcoming of conditions adopted by the FCC in many of its recent merger approvals. For example, to address concerns that price increases might result from the loss of special access competition due to the SBC/AT&T/BellSouth and Verizon/MCI mergers, the FCC imposed a combination of rate rollbacks and freezes.[60] However, these conditions expired after 24 to 30 months, without regard to whether competition had returned to pre-merger levels.

Each condition must be within the Commission's statutory authority. It must also be enforceable in practice. This second factor requires that both the regulator and the conditioned party have a clear understanding of what constitutes compliance. Required actions should be verifiable and measurable. There should be clear schedules. The enforceability of a condition often requires that there be either a compelling inducement for compliance or an effective sanction for noncompliance. A fine that is less than the cost of compliance is less likely to produce compliance than one that equals or exceeds that cost. Similarly, a penalty of a fixed amount will have proportionally more impact on a small company than on a larger one.

If the seller must obtain express regulatory approval to discontinue its public service obligations, the regulator should withhold that approval until the seller has fulfilled its share of the transfer conditions. If jurisdiction over the seller ends at the time of transfer, any condition that applies to the seller must be completed prior to the sale. In the Vermont order approving the Verizon-FairPoint sale, the Public Service Board specified that the "abandonment of service by Verizon and the revocation of its Certificate of Public Good (or the equivalent thereto)" be effective only upon Verizon's completion of the conditions contained in the Verizon-FairPoint transfer approval order.[61]

Sometimes the applicants or other parties propose conditions to the regulator that do not directly address identified public interest concerns arising from the proposed transfer. For example, while a rate decrease might be an appropriate response to evidence that the transfer will result in significant merger efficiencies, it will not fix concerns about a proposed buyer's ability to operate the ILEC business competently. It might even be counterproductive, insofar as it reduces revenues that might be required for the ILEC to provide reliable service. This type of mismatch between proposed conditions and actual public interest concerns often arises with "voluntary commitments" made by applicants in pursuit of regulatory approval, as well as in proposed settlements. The regulator must be prepared to reject proposed conditions that do not cure specific deficiencies in the transfer. On the other hand, "voluntary commitments" can permit applicants to agree to take actions that the regulator might have difficulty enforcing or that would otherwise require it to undertake a lengthy additional regulatory process.

Conditions can provide a safety net to protect against negative consequences that cannot be fully known or assessed in advance. If the sale price is fair and the condition of the business is as represented, regulators stand a reasonable chance of making the right decision about

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[60] *In the Matter of SBC Communications Inc. and AT&T Corp. Applications for Approval of Transfer of Control*, 20 FCC Rcd 18290 (2005), Appendix F, *Conditions; In the Matter of Verizon Communications Inc. and MCI, Inc. Applications for Approval of Transfer of Control*, 20 FCC Rcd 18433 (2005), Appendix G, Conditions; *In the Matter of AT&T Inc. and BellSouth Corporation, Application for Transfer of Control*, 22 FCC Rcd 5662(2007), Appendix F, Conditions.

[61] Vermont PSB Approval Order, 2008 VT LEXIS at ***74-***75.

whether to approve the transfer. If the seller uses its superior knowledge of the business to obtain too high a price and/or strip off too many valuable assets from the sale, the buyer's ability to operate consistently with the public interest will be compromised. Some possible approaches to creating a financial safety net include:

- A requirement that the seller remain financially "at risk" for an extended period of time following the actual transfer of the ILEC's operations to the buyer, by retaining partial ownership of the assets.

- A requirement that the seller place in escrow a portion of the sale proceeds, to be available to the buyer if transition costs significantly exceed the estimated amounts or if the business suffers a precipitous decline in value at the time of or shortly after the transfer is completed.

For those aspects of the ILEC's operations about which the seller is in possession of superior or even non-replicable expertise, as in the case of complex operations support systems and software, the escrow can be used to ensure the seller's commitment to maintain support for such assets over an extended period of time.

B. Rejection and its consequences

Most applications for a change in control of a regulated telecommunications company submitted to state and federal regulators over the past decade have been allowed, albeit with certain conditions. There will, however, be times when the applicants refuse to accept regulatory conditions necessary to conform the transaction to the public interest. There also will be times when conditions cannot remedy regulatory concerns. Under these circumstances, the regulator has a legal obligation to reject the proposed transfer.

With the rejection of a proposed sale of exchanges, regulators then must confront the challenge of regulating an incumbent that has sought to terminate its public service obligations. At one level, the rejection simply means a continuation of the status quo. Whatever regulation has applied to the ILEC with respect to rates, quality of service, and other public service obligations continues uninterrupted. As a practical matter, however, if the ILEC has determined that its best investment opportunities lie elsewhere, [62] the regulator should pay special attention to the incumbent's performance. The investigation of a proposed transfer can also bring to light specific deficiencies in the ILEC's ongoing performance of its public service obligations (e.g., with respect to service quality), particularly if it has decreased its investments in anticipation of selling the assets. The public interest requires a prompt and direct response to any such problems, even if it is clear that the ILEC intends to renew its efforts to find an acceptable buyer and continue to pursue its exit strategy.

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[62] Explaining the company's rationale for selling rural wireline assets, Verizon's CEO stated that these assets "weren't strategic to our long-term vision of the business." Verizon at Goldman Sachs Communacopia Conference, New York, September 17, 2009 / 2:15PM GMT, Thomson Reuters StreetEvents, Final Transcript, at 1.

The regulator might be able to streamline future proceedings and improve the chances of a positive public interest outcome by working with the incumbent to develop an understanding of the type of buyer and the type of transaction that will attain regulatory approval. Such an approach neither binds the regulator nor substitutes for careful ongoing regulation, so long as the ILEC retains its utility status. However, it could provide an otherwise reluctant incumbent with an incentive to maintain its infrastructure and provide high quality-service until a transfer can be arranged that meets the public interest.

Appendix

Initial Filing Requirements

I. Documents

Every document filed in support of an application for transfer of control shall be submitted in electronic, machine-readable and -searchable format. An application shall not be considered to be complete until the applicants have filed the following documents:

A. All contracts that pertain to the proposed transfer, including all attachments, disclosures, and supporting documents, however designated.

B. Investor information

1. Buyer's annual report (SEC Form 10-K) for the current and two prior years
2. Seller's annual report (SEC Form 10-K) for the current and two prior years
3. Written correspondence, presentations, or other documents obtained by either party from any independent source (including but not limited to outside consultants or investment analysts) that opine or comment on the transaction.
4. Transcripts of investor briefings.
5. Investment analyst reports concerning the proposed transaction, issued within 6 months of its public disclosure.

C. Complete filings with federal government agencies and other state public utilities commissions that relate to the proposed transfer:

1. U.S. Securities and Exchange Commission filings that relate to the transfer, including but not limited to Form S-4 (prospectus).
2. U.S. Department of Justice filings
   a. Filings required pursuant to the Scott-Hart-Rodino Act
   b. Filings by either party or any its affiliates in response to a Complaint by the DoJ relating to the transfer
3. U.S. Federal Communications Commission filings
   a. Application for approval of transfer, including all attachments, testimony, or other evidentiary documents filed by either party in support of the application
   b. All letters (including *ex parte* transmittals), memoranda, and pleadings, however styled, filed by either party in support of the transfer.

4. Filings with public utilities commissions in other states
    a. List of all states affected by the proposed transfer.
    b. List of all states for which regulatory approval of the transfer is required. For each state proceeding active at the time of filing, supply the following information, by state:
        (1) Docket number and caption
        (2) Date on which application was filed
        (3) Statutory deadline for completion, if applicable
        (4) Brief description of each document filed with the initial application
        (5) Name and telephone number of designated staff contact (e.g., hearing officer; lead commissioner)
    c. This list shall be updated within 10 days of any subsequent state filing or any material revision of the information required in 4.a.
    d. If the buyer is not presently an ILEC subject to the state's jurisdiction but is an ILEC in other states, provide all quality-of-service reports required to be filed with the public utility commission in the two states in which the buyer presently serves the most access lines.

II. Prefiled Testimony

A. Buyer and seller (transferor and transferee) shall each submit prefiled direct testimony concurrently with the filing of their application. The applicants may address any pertinent matter in their testimony, in addition to the mandatory topics set forth below.

B. Seller's prefiled direct testimony must describe in detail:

1. Seller's objectives for pursuing the proposed transfer
2. The services that the seller proposes to discontinue providing in the state on a permanent basis
3. The assets subject to the transfer and their net book value; any adjustments to valuation; reasons for sale price below or above net book value
4. The number and nature of all customers and contracts specifically excluded from the transfer, and any services or lines of business specifically excluded from the transfer, and disclose:
    a. Seller's aggregate annual revenues from these excluded customers and contracts, services, and lines of business
    b. The extent to which the services provided to these customers or pursuant to these contracts have been offered over shared facilities with services subject to the transfer
    c. Detailed schedules identifying the allocation of costs between services being sold and services being retained
    d. With respect to services to retained customers or provided pursuant

to retained contracts, the terms of any arrangements for sharing of facilities or personnel after the proposed transfer

    e. The fair market value of assets (such as easements or licenses) being retained that were obtained at reduced cost by virtue of the seller's ILEC status.

5. In addition to services addressed exclusively in item 4, any service or line of business of the seller that is specifically excluded from the transfer
    a. Seller's aggregate annual revenues from each such service
    b. The extent to which any such services has been offered over shared facilities with services subject to the transfer
    c. How the seller allocates costs between the services subject to transfer and those being retained
    d. With respect to retained services, the terms of any arrangements for sharing of facilities or personnel after the proposed transfer
6. Any information or information sources the seller made available to the buyer
7. Cost and revenue trends (past 3 years) and projections (current and 2 years out) for services provided over facilities subject to the transfer
8. Seller's obligations with regard to transition of operations support systems within one year of transaction closing
9. Seller's obligations with regard to ongoing technical assistance in maintenance or upgrading of operations support systems (after one year of transaction closing)
10. Seller's discussions with or disclosures to employees regarding the proposed transfer

C. Buyer's prefiled direct testimony must describe in detail:

1. Buyer's due diligence in evaluating the terms of the transaction, including but not limited to:
    a. Inspection and evaluation of assets and condition of business
    b. Independent expert valuation of assets and going business value
    c. Evaluation of comparable sales
2. Buyer's understanding of risks associated with the transaction, including but not limited to
    a. Costs that are uncertain (e.g., financing not yet secured);
    b. Costs subject to change between the agreement date and the closing date
3. Buyer's plans for dealing with the risks and contingencies identified in response 2
4. For every risk (to shareholders) identified in the SEC Form S-4 (prospectus), explain in detail all actions that buyer is taking or intends to take to mitigate potential negative short- and long-term impacts on the buyer and on its customers.
5. Buyer's prior acquisitions of telecommunications businesses valued at $10 million or more within the prior 10-year period. At a minimum, include:

(1) Number of access lines (total and by state)
(2) Purchase price
(3) Portion of total purchase price financed by debt
(4) Whether or not the buyer still owns and operates the telecommunications business, and if not:
(a) When was it sold
(b) Reasons for the sale
(c) Sale price

b. Identify by state, docket number, and date, the orders approving each of the transactions identified in subpart a.; specifically note where approval was subject to regulatory conditions or voluntary commitments.

c. Identify all increases of 5 percent or more in any rate element within three years following the transfer and provide an explanation for the change. Provide this information separately for each transaction and each state.

d. Describe any changes to corporate financial ratings within two years of the transaction.

6. Experience of senior managers with ILEC management and operations, by individual; the specific role each senior manager played in other acquisitions within past 10 years

7. Preparations for business integration and management following completion of the proposed transfer

a. Management structure following the transfer.

b. Buyer's plans to retain existing (seller) management; identification of management to be retained; any financial incentives or other inducements buyer intends to offer existing (seller) management to remain with the buyer after the acquisition closes

c. Division of management among functional areas—basic regulated wireline services, wholesale services, nonregulated competitive services

d. Job impacts, including
(1) Jobs currently being performed within the jurisdiction that will be transferred out-of-state (number, nature of work)
(2) Jobs currently being performed outside the jurisdiction that will be transferred in-state (number, nature of work)

e. Areas of existing (seller) management performance that buyer plans to improve; specific actions buyer will take to accomplish improved performance; risk factors affecting buyer's ability to meet these goals

f. Plans to integrate new employees into its existing workforce, including but not limited to how buyer intends to address differences in pay scales, benefits, work rules, union relationships, and workplace culture

8. Buyer's plans for transition of operations support and other information technology systems

    a. How does buyer plan to support and, if necessary, expand operational support and other information technology systems acquired from seller?
    b. How many separate systems are involved?
    c. If buyer plans to migrate functions presently supported by seller's OSS/IT systems to buyer's OSS/IT systems (either existing or new), how will this transition be accomplished?
    d. What support for seller or other providers does buyer plan to have for accomplishing these transitions? Provide any contracts for purchase of support related to transition and/or ongoing maintenance of OSS/IT systems.
9. Revenue projections (services subject to state jurisdiction); underlying assumptions; sensitivity analysis
10. Cost projections (services subject to state jurisdiction); assumptions; sensitivity analysis
11. Buyer's plans for performing customer service functions, both during and following operational transition
12. Buyer's experience with interconnection and provision of wholesale services to competitors; plans for supporting wholesale customers acquired through transfer
13. Plans to meet customer requirements for advanced telecommunications services (e.g., broadband)
    a. Nature of broadband or other advanced services to be provided
    b. Corporate entity from which such services will be provided to retail customers (e.g., ILEC, other non-ILEC affiliate)
    c. Nature of wholesale broadband services that will be offered
    d. Timetable for system upgrades
    e. Financial analysis of feasibility