

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Frontier Communications :
Corporation, Verizon :
Communications, Inc., Verizon :
North Inc., Verizon South Inc., and :
New Communications of the :
Carolinas, Inc. : 09-0268
:
Joint Application for the approval :
of a Reorganization pursuant to :
Section 7-204 of the Public Utilities :
Act; the Issuance of Certificates of :
Exchange Service Authority :
pursuant to Section 13-405 to New :
Communications of the Carolinas, :
Inc.; the Discontinuance of Service :
for Verizon South Inc. pursuant to :
Section 13-406; the Issuance of an :
Order Approving Designation of :
New Communications of the :
Carolinas, Inc. as an Eligible :
Telecommunications Carrier :
Covering the Service Area :
Consisting of the Exchanges to be :
Acquired from Verizon South Inc. :
upon the Closing of the Proposed :
Transaction and the Granting of All :
Other Necessary and Appropriate :
Relief. :

PROPOSED ORDER

DATED: March 9, 2010

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STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Frontier Communications Corporation, Verizon Communications, Inc., Verizon North Inc., Verizon South Inc., and New Communications of the Carolinas, Inc. : **09-0268**
 :
Joint Application for the approval of a Reorganization pursuant to Section 7-204 of the Public Utilities Act; the Issuance of Certificates of Exchange Service Authority pursuant to Section 13-405 to New Communications of the Carolinas, Inc.; the Discontinuance of Service for Verizon South Inc. pursuant to Section 13-406; the Issuance of an Order Approving Designation of New Communications of the Carolinas, Inc. as an Eligible Telecommunications Carrier Covering the Service Area Consisting of the Exchanges to be Acquired from Verizon South Inc. upon the Closing of the Proposed Transaction and the Granting of All Other Necessary and Appropriate Relief. :

PROPOSED ORDER

By the Commission:

I. INTRODUCTION AND PROCEDURAL BACKGROUND

On June 4, 2009, Frontier Communications Corporation ("Frontier"), Verizon Communications Inc. ("Verizon"), Verizon North, Inc. ("Verizon North"), Verizon South, Inc. ("Verizon South"), and New Communications of the Carolinas, Inc., (collectively, "Joint Applicants") filed a verified Joint Application with the Illinois Commerce Commission ("Commission") pursuant to Section 7-204 of the Public Utilities Act ("Act"), 220 ILCS 5/1-101, *et seq.*, seeking approval of a reorganization (the "Transaction" or "reorganization") and for other regulatory approvals and relief.

Pursuant to 83 Ill. Adm. Code 1700.20(d), the Commission received public comments from 54 individuals. Forty-one of the comments opposed the reorganization. Five of the comments supported the reorganization. Seven comments did not specifically indicate whether they opposed or supported the reorganization but stated they were concerned. One comment was in regards to other issues.

Petitions seeking leave to intervene were filed by the People of the State of Illinois through the Attorney General (“AG”), Citizens Utility Board (“CUB”), Comcast Phone of Illinois, LLC d/b/a Comcast Digital Telephone (“Comcast”), International Brotherhood of Electrical Workers Locals 21, 51, and 702 (“IBEW”), Illinois Public Telecommunications Association (“IPTA”), Level 3 Communications, Inc. (“Level 3”) and the United States Department of Defense and All Other Federal Executive Agencies (“DoD-FEA”). All petitions to intervene were granted.

Pursuant to proper notice, this matter came for hearing before a duly authorized Administrative Law Judge (“ALJ”) of the Commission at its offices in Springfield, Illinois on July 28, 2009 and on August 7, 2009. Appearances were entered by counsel on behalf of Joint Applicants, the AG, CUB, Comcast, IBEW, IPTA, Level 3, DoD-FEA and Staff of the Commission (“Staff”). At the August 7th hearing, the ALJ set a procedural schedule for this docket. The Commission held an additional status hearing on January 11, 2010 and evidentiary hearings on January 19, 2010 and January 20, 2010.

Daniel McCarthy, Executive Vice President and Chief Executive Officer of Frontier Communications Corporation; Kim L. Czak, Assistant Vice President – Carrier Services of Frontier Communications Corporation; Timothy McCallion, President of the West Region for Verizon Communications; Carl E. Ehart, President, Central Region for Verizon Communications, Inc.; Stephen Edward Smith, Vice President of Business Development for Verizon’s Telecom Group; and Billy Jack Gregg, an independent consultant and the principal in the firm Billy Jack Gregg Universal Consulting, testified and presented evidence on behalf of Joint Applicants in support of the Joint Application.

Lee L. Selwyn, President of Economics and Technology, Inc., a research and consulting firm specializing in telecommunications economics, regulation management and public policy, testified and presented evidence on behalf of the AG and CUB, opposing the Joint Application.

Susan M. Baldwin, a consultant specializing in telecommunications economics, regulation and public policy and Randy Barber, President for the Center for Economic Organizing, testified and presented evidence on behalf of IBEW, opposing the Joint Application.

Charles W. King, President of the economic consulting firm of Snavelly, King Majoros O’Connor & Bedell, Inc., testified and presented evidence on behalf of DoD-FEA.

The following witnesses testified and presented evidence on behalf of Staff: Samuel S. McClerren, an Engineering Analyst IV in the Engineering Department of the Telecommunications Division; Mike Ostrander, an Accountant in the Accounting Department of the Financial Analysis Division; Rochelle Phipps, Senior Financial Analyst in the Finance Department of the Financial Analysis Division; Qin Liu, a Rate Analyst III in the Telecommunications Department in the Telecommunications Division; Karen Chang, an Economic Analyst in the Rates Section of the Telecommunications Division; and Stacy Ross, a Program Assistant for the Telecommunications Division.

On January 27, 2010, the ALJ caused the matter to be marked "Heard and Taken."

Joint Applicants, Staff, IBEW, IPTA and DoD-FEA each filed Initial Briefs on February 9, 2010. Reply Briefs were filed by Joint Applicants, Staff and IBEW on February 18, 2010. An ALJ Proposed Order was issued on March 9, 2010.

II. DESCRIPTION OF JOINT APPLICANTS PROPOSED TRANSFER OF CONTROL AND REORGANIZATION

On May 13, 2009, Frontier, Verizon and New Communications Holdings Inc. ("NCH," referred to as "Spinco" in the Distribution and Merger Agreements), a newly created subsidiary of Verizon, formed solely for the proposed reorganization, entered into an Agreement and Plan of Merger (the "Merger Agreement") under which Frontier will acquire approximately 4.8 million access lines (and certain related assets) currently owned by subsidiaries of Verizon in Arizona, Idaho, Illinois, Indiana, Michigan, Nevada, North Carolina, Ohio, Oregon, South Carolina, Washington, Wisconsin and West Virginia as well as portions of California bordering Arizona, Nevada and Oregon ("Territory"). On the same date as the original Merger Agreement, Verizon and NCH entered into a Distribution Agreement.

The Merger and Distribution Agreements are designed to: (a) establish a separate entity (*i.e.*, NCH) as the holding company for Verizon's local exchange, long distance and related business activities in the acquired Territory described above; (b) spin-off the stock of that new entity to Verizon shareholders; and then (c) immediately merge the new entity into Frontier.

The Transaction will be completed through several steps: NCH will serve as the holding company for the local exchange, long distance and related businesses in Illinois and the other affected states that are being transferred to Frontier. NCH currently a subsidiary of Verizon will be merged into Frontier. Frontier will be the surviving entity, and will then own and control the Verizon assets being transferred through the Transaction as well as its current business operations in Illinois.

NCH has two newly formed subsidiaries: (a) New Communications ILEC Holdings Inc. ("NCIH") which will own the stock of Verizon North, New Communications of the Carolinas Inc. (sometimes referred to as "NewILEC") and the other operating ILECs ("incumbent local exchange carrier") in the affected states; and (b) New

Communications Online and Long Distance Inc. (“NewLD”) which will hold the accounts receivables and customer relationships related to the long distance operations (and other operations) in Illinois and the other affected states.

Through a series of intra-corporate stock transfers, Verizon will transfer (or cause to be transferred) the stock of Verizon North, NewILEC, and the other affected ILECs to NCIH. Similarly, Verizon Long Distance LLC (“VLD”) (f/k/a Bell Atlantic Communications, Inc., d/b/a Verizon Long Distance) and Verizon Enterprise Solutions LLC (“VES”) (f/k/a NYNEX Long Distance Company d/b/a Verizon Enterprise Solutions) will transfer its accounts receivables and customer relationships related to its long distance operations in Illinois and the other affected states to NewLD.

The stock of NCH will then be distributed to Verizon shareholders – *i.e.*, NCH will be “spun off” from Verizon to Verizon’s shareholders. Immediately following this spin-off, NCH will be merged into Frontier, and Frontier will be the surviving holding company owning all of the stock of NCH’s subsidiaries, NCIH and NewLD. Once the merger is completed, NCH will cease to exist; thus, NCIH and NewLD will be direct subsidiaries of Frontier.

Frontier will acquire Verizon North’s operations, but it will not acquire all of Verizon South’s operations – it will acquire only Verizon South’s operations in South Carolina, North Carolina, and Illinois. Post-merger, Verizon will continue to own Verizon South, which will continue to serve the territory in Virginia that Verizon currently serves. Accordingly, prior to the spin-off of NCH and its merger into Frontier, Verizon South will assign its assets, liabilities, and customer relationships relating to its ILEC operations in Illinois, South Carolina and North Carolina to NewILEC. Verizon also will transfer the stock of NewILEC to NCIH through a series of intermediate transfers, such that NewILEC will become a direct, wholly owned subsidiary of NCIH and an indirect, wholly owned subsidiary of NCH. After the merger of NCH into Frontier, Frontier will be the parent of NewILEC.

At the completion of the Transaction, Frontier will own and control, and its board of directors and management will manage, the Verizon free-standing telephone operation (or “VSTO”) assets being transferred through the Transaction. Verizon North will be renamed using a “Frontier” name because Frontier will not operate under the Verizon name in any state. For purposes of this Joint Application, however, the name “Verizon North” is used in describing the pre- and post-Transaction structures. Also, Frontier will rename NewILEC to reflect the “Frontier” business name. Frontier will comply with all applicable Commission requirements associated with renaming and/or establishing doing business names for Verizon North, NewLD and NewILEC.

III. APPLICABLE STATUTORY AUTHORITY

A. Section 6-103 of the Act

Section 6-103 of the Act, provides, that:

The capitalization of a public utility formed by a merger or consolidation of two or more corporations shall be subject to the approval of the Commission, but in no event shall the Commission approve a capitalization exceeding the sum of the capital stock of the corporations so consolidated, at the par value thereof, and any additional sum actually paid in cash for improvements; nor shall any contract for consolidation or lease be capitalized in the stock of any corporation whatever; nor shall any corporation hereafter issue any bonds against or as a lien upon any contract for consolidation or merger. In any reorganization of a public utility, resulting from forced sale, or in any other manner, the amount of capitalization, including therein all stocks and stock certificates and bonds, notes and other evidences of indebtedness, shall be such as is authorized by the Commission, which in making its determination, shall not exceed the fair value of the property involved. Issuance of stocks and stock certificates, and bonds, notes or other evidences of indebtedness in connection with any consolidation, merger, or reorganization shall be subject to all the terms of Sections 6-101 and 6-102 of this Act.

B. Section 7-204 of the Act

The Transaction described in the Joint Application and summarized in Section II of this Final Order constitutes a “reorganization” as that term is defined in Section 7-204 of the Act, and therefore requires approval of the Commission pursuant to Section 7-204 of the Act. Section 7-204 of the Act establishes specific criteria for the Commission’s review and approval of “reorganization” and lists specific determinations that the Commission must make in order to approve a reorganization. Section 7-204(b) of the Act states that the Commission shall not approve any reorganization if the Commission finds that the reorganization will adversely affect the utility’s ability to perform its duties under the Act. Section 7-204(b) of the Act further states that in reviewing any proposed reorganization, the Commission must find that:

- (1) the proposed reorganization will not diminish the utility’s ability to provide adequate, reliable, efficient, safe and least-cost public utility service;
- (2) the proposed reorganization will not result in the unjustified subsidization of non-utility activities by the utility or its customers;
- (3) costs and facilities are fairly and reasonably allocated between utility and non-utility activities in such a manner that the Commission may identify those costs and facilities which are properly included by the utility for ratemaking purposes;
- (4) the proposed reorganization will not significantly impair the utility’s ability to raise necessary capital on reasonable terms or to maintain a reasonable capital structure;

- (5) the utility will remain subject to all applicable laws, regulations, rules, decisions, and policies governing the regulation of Illinois public utilities;
- (6) the proposed reorganization is not likely to have a significant adverse effect on competition in those markets over which the Commission has jurisdiction;
- (7) the proposed reorganization is not likely to result in any adverse rate impacts on retail customers.

Finally, Section 7-204(c) of the Act states that the Commission shall not approve a reorganization without ruling on (i) the allocation of any savings resulting from the proposed reorganization; and (ii) whether the companies should be allowed to recover any costs incurred in accomplishing the proposed reorganization and, if so, the amount of costs eligible for recovery and how the costs will be allocated.

C. Section 13-405 of the Act

Section 13-405 of the Act, provides, in relevant part, that:

The Commission shall approve an application for a Certificate of Exchange Service Authority only upon a showing by the applicant, and a finding by the Commission, after notice and hearing, that the applicant possesses sufficient technical, financial, and managerial resources and abilities to provide local exchange telecommunications service.

D. Section 13-406 of the Act

Section 13-406 of the Act, provides, in relevant part, that:

No telecommunications carrier offering or providing noncompetitive telecommunications service pursuant to a valid Certificate of Service Authority or certificate of public convenience and necessity shall discontinue or abandon such service once initiated until and unless it shall demonstrate, and the Commission finds, after notice and hearing, that such discontinuance or abandonment will not deprive customers of any necessary or essential telecommunications service or access thereto and is not otherwise contrary to the public interest. No telecommunications carrier offering or providing competitive telecommunications service shall discontinue or abandon such service once initiated except upon 30 days notice to the Commission and affected customers. The Commission may, upon its own motion or upon complaint, investigate the proposed discontinuance or abandonment of a competitive telecommunications service and may, after notice and hearing, prohibit such proposed discontinuance or abandonment if the Commission finds that it would be contrary to the public interest.

E. Section 13-517 of the Act

Section 13-517 of the Act, provides, in relevant part, that:

(a) Every Incumbent Local Exchange Carrier (telecommunications carrier that offers or provides a noncompetitive telecommunications service) shall offer or provide advanced telecommunications services to not less than 80% of its customers by January 1, 2005.

(c) As used in this Section, "advanced telecommunications services" means services capable of supporting, in at least one direction, a speed in excess of 200 kilobits per second (kbps) to the network demarcation point at the subscriber's premises.

F. Section 13-900 of the Act

Section 13-900 of the Act provides, in relevant part, that:

(a) The General Assembly finds that it is necessary to require the certification of 9-1-1 system providers to ensure the safety of the lives and property of Illinoisans and Illinois businesses, and to otherwise protect and promote the public safety, health, and welfare of the citizens of this State and their property.

(b) For purposes of this Section

...
"9-1-1 system provider" means any person, corporation, limited liability company, partnership, sole proprietorship, or entity of any description whatever that acts as a system provider within the meaning of Section 2.18 of the Emergency Telephone System Act.

...
(c) Except as otherwise provided in this Section, beginning July 1, 2010, it is unlawful for any 9-1-1 system provider to offer or provide or seek to offer or provide to any emergency telephone system board or 9-1-1 system, or agent, representative, or designee thereof, any network and database service used or intended to be used by any emergency telephone system board or 9-1-1 system for the purpose of answering, transferring, or relaying requests for emergency services, or dispatching public safety agency personnel in response to requests for emergency services, unless the 9-1-1 system provider has applied for and received a Certificate of 9-1-1 System Provider Authority from the Commission. The Commission shall approve an application for a Certificate of 9-1-1 System Provider Authority upon a showing by the applicant, and a finding by the Commission, after notice and hearing, that the applicant possesses sufficient technical, financial, and managerial resources and abilities to

provide network service and database services that it seeks authority to provide in its application for service authority, in a safe, continuous, and uninterrupted manner.

(d) No incumbent local exchange carrier that provides, as of the effective date of this amendatory Act of the 96th General Assembly, any 9-1-1 network and 9-1-1 database service used or intended to be used by any Emergency Telephone System Board or 9-1-1 system, shall be required to obtain a Certificate of 9-1-1 System Provider Authority under this Section. No entity that possesses, as of the effective date of this amendatory Act of the 96th General Assembly, a Certificate of Service Authority and provides 9-1-1 network and 9-1-1 database services to any incumbent local exchange carrier as of the effective date of this amendatory Act of the 96th General Assembly shall be required to obtain a Certificate of 9-1-1 System Provider Authority under this Section.

(e) Any and all enforcement authority granted to the Commission under this Section shall apply exclusively to 9-1-1 system providers granted a Certificate of Service Authority under this Section and shall not apply to incumbent local exchange carriers that are providing 9-1-1 service as of the effective date of this amendatory Act of the 96th General Assembly.

G. Eligible Telecommunications Carrier Status

As a new corporate entity, NewLLEC will require a Commission determination under 47 U.S.C § 214(e), which authorizes the Commission to designate carriers as Eligible Telecommunications Carriers or “ETCs” if they offer all the services supported by federal universal support, advertise the availability of charges for such services using media of general distribution within their service areas, and make Lifeline services as defined by 47 C.F.R § 54.401 available to qualifying low-income consumers in their service area.

IV. COMPLIANCE WITH SECTION 7-204 OF THE ACT

A. Section 7-204(b)(1) of the Act provides that “the proposed reorganization will not diminish the utility’s ability to provide adequate, reliable, efficient, safe and least cost public utility service.”

1. Position of Joint Applicants

Joint Applicants asserted that the proposed Transaction meets the requirements of 7-204(b)(1) of the Act, that “the proposed reorganization will not diminish the utility’s ability to provide adequate, reliable, efficient, safe and least cost public utility service.”

Joint Applicants testified that the proposed Transaction would ensure a seamless transition from Verizon to Frontier, with no degradation and no immediate change in

service other than the change in name. For example, no change will occur with respect to Frontier's existing operating entities in Illinois, including any of the Frontier ILECs in Illinois or with respect to any entity holding a controlling interest in them, because the control of these companies will remain with Frontier as it is today. These companies will continue to operate as separate entities under their existing tariffs and Commission regulatory requirements immediately following the Transaction. According to Joint Applicants, Frontier's existing customers will continue to receive the same services, service rates, and service terms and conditions.

Similarly, Joint Applicants stated, the Verizon employees who currently support Verizon's Illinois operations will continue to support those same ILEC operations under Frontier. In each case, Verizon North through the same corporate entity and Verizon South through a new corporate entity will have the same assets and personnel to ensure that the proposed reorganization will not diminish the utility's ability to provide adequate, reliable, efficient, safe and least cost public utility service. In addition, the Verizon properties will be operated on the local manager-based management structure.

Joint Applicants explained that Verizon's existing systems are currently used to support customers in Illinois. These systems support retail ordering and billing, wholesale ordering and billing, network monitoring and maintenance, and all customer support functions. Prior to closing, Verizon will replicate and physically separate these systems from the systems it will continue to use for its own operations after the close. These separate centralized systems that will be dedicated to the operations being acquired by Frontier will be operated on a stand-alone basis for at least 60 days prior to closing. Frontier will coordinate and be in continuous dialog with Verizon as Verizon undertakes the process of replicating its existing systems and establishing standalone versions.

After closing, the customer records and information for customers located in Illinois will be maintained on Frontier's systems that Verizon has replicated, which will be maintained independently from the systems Verizon retains and utilizes to provide service in other states. Therefore, the Verizon customers will not be served on a new system (which was the case for Hawaiian Telcom and for the Verizon FairPoint Communications, Inc. "FairPoint" transaction in New England), because after closing Frontier will be using replicated versions of the same systems in place and used prior to closing in Illinois and will have the advantage of employees experienced with those systems who will continue with the business.

FairPoint experienced operational problems after it moved retail and wholesale customers to new customer care and billing systems that FairPoint had designed and built to completely replace Verizon's systems and to run the business it acquired. Similarly, Hawaiian Telcom encountered problems as a result of creating and cutting over data to new systems. Thus, in both the Hawaiian Telcom and FairPoint transactions, the buyers chose to develop operational, business or customer support and financial systems from scratch and then cutover to those new systems to operate the acquired businesses.

By contrast, Frontier will not be developing any new systems and will not be cutting over from Verizon's existing systems. Instead, Frontier will use the same operational systems used by Verizon prior to closing to provide service. Even if Frontier decides to transition to its own existing systems several years from now, it would be moving data to a currently functioning operations support system ("OSS"), which can accommodate and be used to serve the Verizon customers. The \$94 million maintenance fee that Verizon and Frontier have negotiated may be reduced over time if Frontier chooses to perform the maintenance in-house, if it transitions to its own existing systems, or if it finds an alternate vendor for those maintenance services. In other words, Frontier's experience and the structure of this Transaction will avoid the problems those buyers experienced.

Frontier also argued that it is a very different company than FairPoint in New England or Hawaiian Telcom in Hawaii. Frontier is a successful business with a strong management team that provides service to over two million access lines and a strong financial position. Frontier has substantial experience successfully acquiring and integrating telephone operations, including 750,000 access lines from GTE and 1.1 million access lines from Global Crossing, an acquisition that almost doubled Frontier's size and that included a large number of lines in Illinois.

Joint Applicants disputed the assertions of IBEW witness Susan Baldwin that Verizon's service quality in the VSTO areas has been diminishing, stating that she has inappropriately attempted to apply the Federal Communications Commission's ("FCC"), Automated Reporting Management Information System ("ARMIS"), data on state-by-state basis. Joint Applicants also disputed Ms. Baldwin's quality comparisons between Frontier and Verizon, explaining that FCC ARMIS data is not gathered consistently between different companies, resulting in an apples-to-oranges comparison and explaining that ARMIS data is only a starting point. In response to Ms. Baldwin and other intervenors' assertions about Frontier's quality of service, Joint Applicants pointed out that Staff witness Samuel S. McClerren concluded that both Verizon and Frontier have a history in Illinois of successfully meeting the Commission's service quality standards.

Joint Applicants similarly refuted IBEW's attempt to leverage the transactional risks listed in the Security Exchange Commission's ("SEC") Form S-4 into a parade of horrors about what is likely to occur in the Transaction. Rather, Joint Applicants stated, it is a list of potential risks to any merger transaction, and the Form S-4 is not intended to assign any probability to those risks.

The Joint Applicants stated that any residual question regarding this criterion is addressed by Staff Conditions 1 and 2 which were proposed by Staff witnesses Mr. McClerren and Ms. Rochelle Phipps. Condition 1 requires Frontier to meet or exceed Verizon's current average service metrics or have the dividends related to those services restricted until service meets the specified metrics. Condition 2 requires Frontier to keep no less than \$50 million available for the capital expenditures by the New Frontier Illinois ILECs. Both of these conditions will remain in effect for five years or until Frontier achieves investment grade credit ratings with at least two of the

reporting services, whichever occurs first, but can be re-implemented if Frontier's credit rating falls below its current level. Staff Reporting Requirements 2 and 3 will allow the Commission to monitor Frontier's progress.

Similarly, Staff witness Mr. McClerren proposed Condition 3, which will require Frontier to coordinate closely with Staff, particularly with the Chief Engineer of the Telecommunications Division, to ensure that the Commission is aware of any future cutover of systems from the replicated Verizon systems to a Frontier system. They will provide plans and obtain the prior written approval of the Chief Engineer.

Staff's proposed conditions are supported by AG/CUB Conditions 1-5. Particularly, AG/CUB Condition 5 will help the Commission monitor Frontier's provision of responsive customer service in its business offices. AG/CUB Conditions 15-21 will provide further stability to retail customer service for the New Frontier Illinois ILECs by assuring that Staff, as well as the AG and CUB, are kept apprised of OSS changes within Frontier that could have customer impacts.

Joint Applicants contended that with or without the imposition of those conditions, this reorganization meets the requirements of Section 7-204(b)(1) of the Act.

2. Position of Staff

Staff opined that the Transaction with conditions satisfies the requirements of Section 7-204(b)(1) of the Act.

Mr. McClerren offered Staff's analysis and evaluation of the financial implications of the proposed reorganization on the New Frontier ILECs under Section 7-204(b)(1) of the Act. Mr. McClerren recommended that the Commission place two conditions on approval of the proposed reorganization to assure that it will not diminish the New Frontier ILEC's ability to provide adequate, reliable, efficient, safe and least cost service. One condition addressed service quality, and the other addressed the OSS.

Staff pointed out that both Frontier and Verizon currently have service territories in Illinois, so Mr. McClerren has substantial knowledge regarding certain aspects of the Illinois operations of both companies. Mr. McClerren noted that both of these companies are generally able to provide telecommunications services, and have done so in Illinois for many years. He further observed that the companies generally achieve reasonable levels of service quality, and both companies have a history of successfully meeting the requirements in 83 Ill. Adm. Code 730 ("Part 730").

Of particular interest to Staff, and in Mr. McClerren's estimation a basis for approval of the proposed Transaction, was the fact that Frontier appears to focus its business upon serving in smaller, primarily rural markets. On the other hand, Verizon's corporate focus, based upon the testimony of Verizon witness Carl E. Erhart, was on its wireless business and "high density urban and suburban areas."

Mr. McClerren observed, the properties that are subject to this reorganization are primarily rural. In Mr. McClerren's opinion, if a company wishes to focus on its

operations in high-density urban and suburban areas, it is less likely to expend either effort or capital to properly support its rural operation, resulting in less than optimal investment, service and growth in the rural operation. Mr. McClerren also considered the converse to be true; if a company's management considers the rural operation to be both important to the company's long term business plan and potentially lucrative, it will likely expend both effort and capital to properly support that area. In short, Mr. McClerren considered Frontier's acquisition of the Illinois telephone properties that are subject to this reorganization to be consistent with its long-term plan, and with the interests of the customers in those areas.

However, Mr. McClerren expressed reservations regarding the proposed Transaction. Mr. McClerren's reservations were as follows:

1. Both Frontier and Verizon have, in recent years, had difficulty satisfying all Part 730 service quality standards, including, in the case of Verizon, Business Office Answer Time, Service Installations, and Out of Service < 24 Hours, and in the case of Frontier, Repair Office Answer Time, Business Office Answer Time and Out of Service < 24 Hours;
2. Companies which recently purchased ILEC properties from Verizon, including Hawaii Telecom, FairPoint and Idearc, have experienced significant problems, both financially and with their service quality;
3. Additionally, in their direct testimony, Joint Applicants, rather than describing in any detail the manner in which the transition of operations support systems functions from Verizon to Frontier will be conducted, merely indicated that any integration would not take place for at least 12 months after the merger is complete. This lack of detail was troubling; since customers of ILEC properties in both New England and Hawaii have recently experienced severe service quality deterioration after other entities acquired those properties from Verizon;
4. Mr. McClerren considered Frontier's due diligence in review of this reorganization to be lacking.

Accordingly, with respect to Section 7-204(b)(1) of the Act, Mr. McClerren opined that the reorganization, as proposed, would diminish the utility's ability to provide adequate, reliable, efficient, safe and least-cost public utility service, and for that reason he was compelled to recommend that the Commission not approve it as proposed.

Mr. McClerren formulated two conditions which would, were the Joint Applicants were to accept and the Commission to impose, cause him to no longer recommend rejection of the proposed Transaction pursuant to Section 7-204(b)(1) of the Act. One of these conditions addresses service quality, and the other addresses the operations support systems.

Regarding service quality, Mr. McClerren observed that the Commission has in approving recent Section 7-204 of the Act reorganizations of incumbent local exchange

telecommunications carriers, ordered that service quality in the acquired territories will not diminish relative to current levels, which is typically above the minimum levels of service quality required by Part 730. To derive current levels for this purpose, the most recent 12-months performance has been averaged and used as a service quality “floor.” If the service quality in the acquired territory diminishes relative to its pre-merger levels, stated Mr. McClerren, monetary transfer payments from the Illinois properties or operating subsidiaries to the corporate parent will be halted. In effect, if service quality diminishes relative to pre-merger levels, additional resources are to be invested in Illinois telecommunications facilities until the service quality degradation is resolved. Accordingly, with that concept in mind and in conjunction with Staff witness Ms. Phipps, Mr. McClerren recommended the Commission condition its approval of the reorganization on Staff Conditions 1 and 2.

While the Joint Applicants disputed Mr. McClerren’s analysis and recommendation, Frontier nonetheless stated that it was willing to accede to the imposition of the conditions proposed by Mr. McClerren. During cross examination, Mr. Daniel McCarthy presented Frontier Corrected Exhibit 8.4.A, which contained all of the conditions Staff recommended, with minor modifications to address Frontier’s stated implementation concerns. Mr. McClerren indicated that with the changes contained in Frontier Corrected Exhibit 8.4.A and all of which are restated above, Staff would not object to the approval of the proposed Transaction relative to Section 7-204(b)(1) of the Act.

3. Position of IBEW

IBEW raised concerns about Frontier’s ability to meet the requirement of Section 7-204(b)(1) of the Act. IBEW contended that Frontier’s lack of financial fitness would jeopardize the company’s ability to provide safe, reliable, efficient, least-cost service to its customers. According to IBEW, the Transaction that was presented to the Commission is not in the public interest. The risks and uncertainties are enormous. Whatever benefits may exist from Frontier’s promises or intentions to increase broadband penetration are meaningless if Frontier cannot afford to spend the money or if Frontier does not have enough people to do the work.

4. Commission Analysis and Conclusion

The Commission finds the evidence presented by Joint Applicants, Staff, and IBEW demonstrates that the proposed reorganization will adversely impact Frontier's ability to provide adequate, reliable, efficient, safe and least-cost utility service.

The Joint Applicants argued that the replication process of the operation support systems will not diminish service quality nor will it adversely impact Frontier's ability to provide adequate, reliable, efficient, safe and least-cost utility service. The Staff contended that imposing conditions and reporting requirements will ensure that reliable, efficient, safe and least-cost utility service will not be diminished to Illinois customers. However, the record evidence shows that Frontier's ability to provide adequate, reliable,

efficient, safe, least-cost utility and service quality will be diminished if this Transaction were to be approved.

According to Staff witness Mr. McClerren, both Frontier Illinois operating ILECs and Verizon have, in recent years, had some difficulty meeting the minimum key standards contained in Part 730. The key Part 730 standards are Toll & Assistance Operator Answer Time, Directory Assistance Operator Answer Time, Repair Office Answer Time, Business Office Answer Time, Service Installations, Out of Service < 24 Hours, and Trouble Reports.

Ms. McClerren characterized the performance of the nine Frontier Illinois operating ILECs as poor relative to the Repair Office Answer Time and Out of Service < 24 Hours standards and unacceptable relative to the Business Office Answer Time standard. Mr. McClerren concluded that given Frontier's poorer performance relative to Verizon's performance on Repair Office Answer Time, Business Office Answer Time, and Out of Service < 24 Hours, service quality would likely decline in the current Verizon North and Verizon South territories if the proposed reorganization is allowed to occur. Mr. McClerren further stated that because Frontier had continuously failed to satisfy the Business Office Answer Time, Staff expressed to Frontier representatives that it was prepared to initiate a hearing under Section 730.120 of the Act for the purpose of imposing penalties.

Mr. McClerren recommended conditions addressing service quality, and operation support systems. The Commission is of the opinion the conditions proposed are inadequate considering the problems Frontier has had with meeting the minimum key standards of Part 730. Moreover, it seems likely that Frontier will have a more difficult time meeting the minimum key standards of Part 730 due to the replication process of the operation support systems, along with other factors that come into play. For instance the burden of the \$94 million maintenance fee that Verizon and Frontier have negotiated is of a concern. Frontier may choose to perform the maintenance in-house, if it transitions to its own existing systems, or if it finds an alternate vendor for those maintenance services to avoid this enormous fee requirement. The evidence shows there is a significant risk that problems could occur if the transition is made too prematurely so as to create a potential for harm to Illinois customers. When weighed against the many risks of the Transaction, including, among others, the risk of systems integration, the purported benefits of the Transaction do not justify approval.

The Commission does not follow Staff's reasoning that service quality will not be diminished if conditions are imposed, when Frontier has had problems in the past in meeting the minimum key standards of Part 730. The task of meeting the requirements will almost be impossible if this Transaction were to be improved. For instance, Frontier's total Illinois access lines would be increasing from 97,000 to over 670,000 lines. Frontier would also be almost tripling its size and will be burdened with an enormous amount of approximately \$3.3 billion in debt. The financial pressure along with more wirelines to handle leads the Commission to conclude that service quality will

certainly be diminished. The ultimate consequences of diminished quality service will be borne by Illinois customers.

Joint Applicants contended that the replication process of the operation support systems will be seamless prior to closing. However, Joint Applicants assurance is unconvincing. Companies which have recently purchased ILEC properties from Verizon have experienced significant problems in service quality. For example, Verizon's and FairPoint's initiated petitions promising the proposed reorganization would not result in harm to the public. The petitions indicated there would be no adverse effect on services, and that customers would benefit because of FairPoint's experience and success in dealing with rural and small urban areas. However, FairPoint experienced numerous service quality, billing and customer service problems. The Commission agrees with AG/CUB witness Dr. Selwin's assessment that Frontier's assertion that prior to closing, Verizon can simply "replicate and physically separate these systems from the systems [Verizon] will continue to use for its own operations after the close" and that "Frontier will be able to validate and confirm that the principal operating systems have been replicated properly in advance of closing" seems incredibly simplistic.

In addition, the Commission is concerned that Frontier's lack of financial fitness (discussed under Section 2-204(b)(4) of the Act), will jeopardize the company's ability to provide safe, reliable, efficient, least-cost service to its customers. IBEW witness Ms. Baldwin explained why these financial risks have a direct impact on the provision of reliable service to the public. Specifically, she testified:

The serious financial risks that Mr. Barber describes in detail jeopardize the quality of service that Frontier would offer consumers for several reasons. The post-Transaction financial constraints on Frontier would limit its ability to follow through on its promise to expend more on capital investment than Verizon has. Instead, in its pursuit of synergies, Frontier would face strong economic incentives to cut costs, particularly where the anticipated cost of such investment is not offset by the anticipated increase in revenue (or decrease in expenses). As a result, for example, consumers may experience long delays for the restoration of out-of-service troubles.

The record also does not support a finding that Frontier will be any more effective than Verizon in expanding the scope and quality of broadband services in the Illinois service areas it proposes to acquire from Verizon. To the contrary, the evidence shows that it is very unlikely that a smaller, less experienced operator would be able to support such an investment.

The Commission therefore finds that the evidence presented by Joint Applicants, Staff, IBEW, and the AG/CUB shows that the proposed reorganization will diminish the utility's ability to provide adequate, reliable, efficient, safe and least-cost public utility service.

- B. Section 7-204(b)(2) of the Act provides that "the proposed reorganization will not result in the unjustified subsidization of non-utility activities by the utility or its customers," and**

Section 7-204(b)(3) of the Act provides that "costs and facilities are fairly and reasonably allocated between utility and non-utility activities in such a manner that the Commission may identify those costs and facilities which are properly included by the utility for ratemaking purposes."

1. Position of Joint Applicants

Joint Applicants asserted that the proposed reorganization complies with Section 7-204(b)(2) and (b)(3) of the Act. Section 7-204(b)(2) requires the Commission to find that "the proposed reorganization will not result in the unjustified subsidization of non-utility activities by the utility or its customers," and Section 7-204(b)(3) requires a finding that "costs and facilities are fairly and reasonably allocated between utility and non-utility activities in such a manner that the Commission may identify those costs and facilities which are properly included by the utility for ratemaking purposes."

Joint Applicants contended that the proposed reorganization will not result in the unjustified subsidization of non-utility activities by Frontier or its customers in its current exchanges or in any of the Verizon exchanges.

Joint Applicants testified that, operationally, the reorganization will not trigger any changes in the way costs are allocated. Specifically, the Verizon North exchanges will continue to be operated through the same corporate entity and the Verizon South exchanges will be operated by a new, but virtually identical corporate entity. Therefore, the reorganization will not create any opportunities for unjustified subsidization of non-utility activities by the utility or its customers. In addition, there will be no basis in the reorganization to change how costs and facilities are allocated between utility and non-utility activities.

In addition, nothing about the proposed Transaction will change the ability of Frontier to comply with the Commission's rules and regulations regarding cost allocations and subsidization. Frontier will continue to comply with the Commission's cost allocation methods. Likewise, the management employees of Verizon who are currently responsible for complying with those provisions have expertise in complying with these rules. Frontier expects that the Verizon employees who move over to Frontier as part of this Transaction will, along with Frontier managers, continue to apply their expertise to insuring that their respective operating ILEC companies will comply with the rules and regulations of the Commission. Nothing about this merger will change that.

Staff witness Mike Ostrander proposed and Frontier agreed to Condition 4, which requires Frontier to comply with certain requirements allowing staff access to Frontier's books and to undertake and share with Staff an internal audit to ensure compliance with

the subsidization rules. Therefore, the proposed reorganization will not impact the ability of Frontier to fairly and reasonably allocate its costs and facilities between utility and non-utility activities in such a manner that those costs and facilities are appropriately included by Frontier in setting rates for non-competitive telecommunications services. According to the Joint Applicants, this proposed reorganization meets the criteria of Sections 7-204(b)(2) and (b)(3) of the Act.

2. Position of Staff

Mr. Ostrander conducted an analysis of this issue for Staff, determining that the proposed reorganization does not impact the opportunity for the subsidization of non-utility activities of Frontier by utility operations. Mr. Ostrander stated that no change that will occur that affects the opportunity for Frontier to subsidize non-utility activities by the utility operations. Mr. Ostrander observed that, in his direct testimony, Frontier witness Mr. McCarthy testified that the proposed reorganization will not result in the unjustified subsidization of non-utility activities by Frontier or its customers in its current exchanges or in any of the Verizon exchanges.

Mr. Ostrander observed that Frontier is subject to the cost allocation requirements of 83 Ill. Adm. Code 711 ("Part 711"), its cost allocation manual, and FCC cost allocation rules, and that the proposed Transaction will not change the existing cost allocation procedures or accounting methods, as Mr. McCarthy testified. In addition, Frontier agreed to Staff Condition 4, as further evidence of compliance with Section 7-204(b)(2) of the Act.

Frontier did not object to the third condition but, initially proposed that the condition remain in effect for three years after closing of the proposed Transaction. In reply testimony, Mr. Ostrander stated that there is no "clear end date" for Illinois public utilities to be compliant with Sections 7-204(b)(2) and 7-204(b)(3) of the Act. Frontier is not relieved of the obligation to avoid cross-subsidizing its competitive activities with its competitive activities by the passage of time after hypothetical Commission approval of the Transaction, nor is it relieved of the obligation to reasonably allocate the costs of its facilities between utility and non-utility activities in that manner. Mr. Ostrander observed that both of these requirements are embodied in Commission rules that apply independent of approval of the Transaction. In surrebuttal testimony, Mr. McCarthy stated that Frontier did not object to filing an annual internal audit report to assure the Commission that Frontier is continuing to properly apply cost allocation principles. However, Frontier did note that should the annual reporting condition become an ongoing and unnecessary burden Frontier may seek to have the annual reporting condition revised.

Mr. Ostrander concurred with Mr. McCarthy that the proposed reorganization does not impact the ability of Frontier to fairly and reasonably allocate costs and facilities between utility and non-utility activities in such a manner that the Commission may identify those costs and facilities which are properly included by the utility for ratemaking purposes. Both agreed that no change will occur that affects the method used by Frontier to reasonably allocate costs between utility and non-utility activities. In

direct testimony, Mr. McCarthy testified that the proposed reorganization will not impact the ability of Frontier to fairly allocate its costs and facilities between utility and non-utility activities.

Mr. Ostrander offered that the Commission can be assured that Frontier will reasonably allocate its costs and facilities because Frontier is subject to the cost allocation requirements of Part 711, its cost allocation manual, and FCC cost allocation rules. Mr. Ostrander stated that the proposed Transaction will not change the existing cost allocation procedures or accounting methods, as testified to by Mr. McCarthy. In addition, Frontier agreed to Staff Condition 4, which serves as further evidence of compliance with Section 7-204(b)(3) of the Act.

3. Commission Analysis and Conclusion

The evidence presented by Joint Applicants and Staff support our findings under Sections 7-204(b)(2) and (b)(3) of the Act. The Commission finds that no change will occur that affects the opportunity for Frontier to subsidize non-utility activities by the utility operations and that the proposed reorganization will not result in the unjustified subsidization of non-utility activities by Frontier or its customers in its current exchanges or in any of the Verizon exchanges. The Commission further finds that the proposed reorganization does not impact the ability of Frontier to fairly and reasonably allocate costs and facilities between utility and non-utility activities in such a manner that the Commission may identify those costs and facilities which are properly included by the utility for ratemaking purposes.

C. Section 7-204(b)(4) of the Act provides that “the proposed reorganization will not significantly impair the utility’s ability to raise necessary capital on reasonable terms or to maintain a reasonable capital structure.”

1. Position of Joint Applicants

Section 7-204(b)(4) of the Act states that in approving a proposed reorganization, the Commission must find that “the proposed reorganization will not significantly impair the utility’s ability to raise necessary capital on reasonable terms or to maintain a reasonable capital structure.” Frontier testified that it has a strong income statement and balance sheet and is financially capable of operating the acquired properties. Joint Applicants stated that the Transaction will bring about no change in the capital structure of Verizon North or Verizon South, and will not alter the economics of the utilities’ regulated operations. Joint Applicants testified that the utilities generate sufficient cash flows to fund their operations, and that they will not require issuance of debt. Accordingly, the utilities internally generate sufficient cash to fund the expenditures necessary to meet service quality standards. Joint Applicants asserted that the Transaction will not change that fact and will not create any need to raise capital. Accordingly, the Joint Applicants argued that the requirements of Section 7-204(b)(4) of the Act are met.

Frontier testified that as a parent it has a strong income statement and balance sheet and is financially capable of operating the acquired properties. Frontier explained that it will continue to be financially strong following the closing of the proposed Transaction. In fact, Joint Applicants argued that its financial position will be improved. By deleveraging its balance sheet and by decreasing both its per-share dividend payout and dividend payout ratio, Frontier will emerge from the Transaction as a stronger, more stable competitor with a financial structure and level of cash flow that will enable it to make investments in the acquired service territories, including in broadband, and to provide even more efficient service in these areas.

Frontier testified that the combined company will be financially stronger than a standalone Frontier in several critical respects. For example, on a pro forma basis for 2008, the combined company would have had free cash flow of over \$1.4 billion, as compared to approximately \$500 million for Frontier on a stand alone basis. Free cash flow is defined as after-tax cash from operations less cash for capital investments. The Transaction will result in significant free cash flow accretion in the second full year of operation.

Frontier has also revised its dividend policy. At the discretion of its Board of Directors, Frontier currently pays an annual cash dividend of \$1.00 per share of Frontier common stock. After the closing of the proposed Transaction, Frontier intends to change its dividend policy to pay an annual cash dividend of \$0.75 per share of Frontier common stock, reducing its dividend by 25% – from \$1.00 to \$0.75 per share – effective with the close of the Transaction. This will result in the ratio of Frontier's dividend payout of its free cash flow decreasing from almost 65% on a standalone basis to approximately 43% on a pro forma basis for 2008. Frontier believes that this dividend policy, and associated reduced dividend payout ratio, affords the combined company the financial flexibility to use the additional free cash flow to invest in the newly acquired Verizon territory, offer new products and services, and increase broadband capability in its markets over the next few years.

According to the Joint Applicants, as a result of the acquisition of Verizon, Frontier's leverage ratio (net debt divided by earnings before interest, taxes, depreciation and amortization, or "EBITDA") is projected to decrease from 3.8 times to 2.6 times, which is substantially better than the leverage ratios of Frontier's peer group. Frontier expects to achieve a credit rating approaching investment grade, which will provide Frontier with improved access to the capital markets, thereby increasing Frontier's flexibility to further manage its balance sheet and/or invest in new products for its customers – although Joint Applicants also made clear that there will be no need to raise any capital for the operations of the VSTO ILECs.

Based on its financial analysis, Frontier projected that following the Transaction Frontier will be able to generate significant free cash flow, and will be able to attract additional capital, if necessary, to provide high quality service and effectively expand broadband deployment that it has planned. Frontier testified that, as a result, Frontier will have the financial flexibility and resources to make the needed investments in the network and to expand broadband deployment over time.

Through data request responses, entered into the record by Staff, Joint Applicants also demonstrated that the VSTO exchanges generate positive cash flows. Based on Conditions 1 and 2 proposed by Staff witnesses Mr. McClerren and Ms. Phipps, those cash flows will be insulated if there is a reduction of service quality.

Thus, with the inclusion of these conditions, Joint Applicants argued this proposed reorganization meets the criteria of Section 7-204(b)(4) of the Act.

2. Position of Staff

Ms. Phipps offered Staff's analysis and evaluation of the financial implications of the proposed reorganization on Frontier North, Inc. and Frontier Communications of the Carolinas, Inc., respectively the "New Frontier ILECs" under Section 7-204(b)(4) of the Act.

Ms. Phipps recommended that the Commission place two conditions on approval of the proposed reorganization to assure that it will not significantly impair the New Frontier ILECs ability to raise necessary capital on reasonable terms or to maintain a reasonable capital structure for three reasons.

First, Ms. Phipps observed, Frontier is the only source of external capital for the New Frontier ILECs. Therefore, the New Frontier ILECs' ability to raise external capital on reasonable terms depends on Frontier's ability to raise external capital on reasonable terms.

Second, Ms. Phipps noted that Frontier's ability to raise necessary capital on reasonable terms is questionable for the reasons explained hereafter.

Third, in Ms. Phipps' judgment, Frontier's ability to raise necessary capital on reasonable terms is not a required factor for meeting the criteria specified in Section 7-204(b) of the Act because the New Frontier Illinois ILECs generate sufficient cash internally to fund the expenditures necessary to meet service standards. Thus, if the New Frontier Illinois ILECs retain a portion of the cash they generate sufficient for maintaining adequate service, an external source of capital is unnecessary because the New Frontier Illinois ILECs will have "the ability to raise necessary capital" (through the retention of internally generated cash) within the meaning of Section 7-204(b)(4) of the Act. Finally, given that the New Frontier Illinois ILECs are expected to generate internally sufficient cash flow to meet service standards, Ms. Phipps recommended Staff Conditions 1 and 2, to ensure that maintenance of service quality has a higher claim to the New Frontier Illinois ILECs' internally generated cash flow than the financial needs of their affiliates.

Ms. Phipps noted that, pursuant to a Distribution Agreement, Verizon will transfer certain of its ILECs to NCH. NCH, which is referred to as "Spinco" in the Distribution and Merger Agreements, is a newly created subsidiary of Verizon, formed solely for the proposed reorganization. With respect to the Illinois Verizon properties, Verizon will transfer Verizon South's local exchange operations to New ILEC, a direct subsidiary of

NCIH, and an indirect subsidiary of NCH. Verizon will also transfer Verizon North to NCIH. Verizon will distribute NCH stock to Verizon shareholders in exchange for a \$3.333 billion payment comprising cash and debt relief.

Ms. Phipps further noted that, immediately following the spin-off of NCH stock to Verizon shareholders, NCH will merge into Frontier, and Verizon shareholders will receive newly issued shares of Frontier valued at approximately \$5.247 billion. Pursuant to a Merger Agreement, Frontier will acquire NCH, including Verizon North and NewLEEC, and continue to operate those properties as two separate Illinois local exchange companies named New Frontier ILECs.

Ms. Phipps further observed that NCH will issue debt and use the proceeds to pay Verizon an amount that equals the lesser of (x) \$3.33 billion and (y) Verizon's estimate of its tax basis in NCH minus the outstanding long-term debt of NCH and its subsidiaries on the distribution date ("Distribution Date Spinco Indebtedness"). This payment from NCH to Verizon is the "Special Payment," and the related debt issued by NCH (which will become Frontier's debt obligation following the merger) is the "Special Payment Financing." If the Special Payment is less than \$3.333 billion, then NCH will issue "Spinco Securities" to Verizon, in an amount equal to such difference.

Ms. Phipps observed that Frontier is not obligated to accept the Special Payment Financing nor, if applicable, the Spinco Securities under any of the following circumstances:

- Either the weighted-average life of the financing and the securities, together with Distribution Date Spinco Indebtedness, is less than five years, or any of the Special Payment financing or the Spinco Securities would have a final maturity of earlier than January 1, 2014 (other than bridge financing up to \$600 million);
- The financing or the securities or the Distribution Date Spinco Indebtedness would be secured by assets of any operating company;
- The terms or provisions of such financing or securities or Distribution Date Spinco Indebtedness would be prohibited by or result in a default under Frontier's existing credit agreements or indentures;
- The proposed covenants and other terms and conditions (excluding the terms of Spinco Securities set forth in Exhibit G of the Distribution Agreement and the rate, yield or tenor thereof) are not substantially in accordance with prevailing market terms for similarly sized loan bank borrowings or capital issuances by companies similar in size and credit ratings to Frontier and the effect of such covenants and provisions would be materially adverse to post-merger Frontier; or
- The weighted-average annual cash interest rate of the Special Payment Financing, the Spinco Securities and the Distribution Date Spinco

Indebtedness exceeds 9.5% (unless Frontier determines a higher rate would not be unduly burdensome).

Ms. Phipps observed that, during cross-examination, Frontier witness Mr. McCarthy testified that Frontier has not secured a financing commitment, but based on “robust interest” expects to obtain 50%-100% of the special payment financing during the first quarter of 2010, which Frontier would hold in an escrow account until the closing of the Transaction, and also testified that the interest rate that would be available to Frontier is approximately 8%.

Ms. Phipps testified that since the Joint Applicants are seeking Commission approval of the proposed reorganization, they should be required to notify the Commission of the exact terms of the Special Payment Financing and Spinco Securities that the Joint Applicants issue in connection with the proposed reorganization. Therefore, Ms. Phipps recommended the Commission adopt the Staff Reporting Requirement 1.

Ms. Phipps testified that the New Frontier Illinois ILECs currently generate more cash than they require for capital expenditures. In the event the New Frontier Illinois ILECs need additional funds to support capital expenditures, Frontier would provide capital to the operating companies through either inter-company loans or capital infusions. Ms. Phipps understood Frontier to assert that it will access capital markets utilizing the issuance of public bonds and bank term loans. As shown on the table below, Verizon’s credit ratings are five to six notches higher than Frontier’s ratings. As such, Ms. Phipps was of the opinion it will be more challenging for Frontier to raise capital for the New Frontier ILECs than it would be for Verizon. Ms Phipps offered the following table to demonstrate this.

Issuer Ratings and Senior Unsecured Debt Ratings of Verizon, Verizon North and Frontier			
	Moody’s Investors Service	Standard & Poor’s	Fitch Ratings
Verizon	A3 / Negative	A / Negative	A / Stable
Verizon North	A3 / RPD*	A / Negative	A / Negative
Frontier	Ba2 / RPU*	BB / Stable	BB/ Positive
* “RPD” means Review for Possible Downgrade and “RPU” means Review for Possible Upgrade.			

Ms. Phipps described her concerns regarding Frontier’s financial strength as it pertains to the New Frontier ILECs’ ability to provide reasonable and adequate service at reasonable cost. Foremost, Ms. Phipps observed that Frontier has an issuer rating of “Ba2” from Moody’s Investors Service (“Moody’s”), “BB” from Standard & Poor’s (“S&P”) and Fitch Ratings. Frontier’s current issuer credit ratings are two rating notches below the minimum investment grade credit rating of Baa3/BBB-/BBB-. Ms. Phipps noted that, according to Moody’s: “[o]bligations rated Ba are judged to have speculative elements

and are subject to substantial credit risk.” Similarly, Ms. Phipps observed that S&P states:

An obligation rated BB is less vulnerable to nonpayment than other speculative issuers. However, it faces major ongoing uncertainties or exposure to adverse business, financial or economic conditions which could lead to the obligor’s inadequate capacity to meet its financial commitment on the obligation.

Ms. Phipps understood Frontier to argue that, “two credit rating agencies (Moody’s and Fitch) put Frontier on a positive credit watch the day the proposed Transaction was announced, thereby suggesting Frontier’s credit rating may improve following the closing of the Transaction, based upon the projected capital structure.” However, Ms. Phipps directed the Commission’s attention to a statement by Fitch Ratings that an upgrade may be limited to one notch “due to the ever-present integration risks in large telecom transactions and lower near-term financial flexibility as the company incurs integration costs, invests to expand broadband availability and only begins to realize synergies.” Frontier attaining investment grade ratings following the proposed reorganization is questionable. Therefore, in Ms. Phipps’ opinion, even after the proposed reorganization, Frontier’s financial condition might not be sufficiently strong to eliminate concerns about its capacity to meet its debt servicing obligations during adverse conditions without transferring cash from New Frontier ILECs that is necessary for maintaining the New Frontier ILECs’ service quality.

Moreover, Ms. Phipps pointed out that Frontier’s management of the integration of the New Frontier ILECs is an important factor in Moody’s and S&P’s assessments of Frontier’s creditworthiness. Ms. Phipps further directed the Commission’s attention to statements by Moody’s and S&P that Frontier’s ability to manage its post-merger capital structure and operations successfully will be key drivers of Frontier’s post-merger credit rating. Specifically, Ms. Phipps observed, Moody’s notes:

Moody’s review of Frontier’s ratings is focused on the final capital structure of the combined entity following the merger, the substantial challenges Frontier faces in integrating a company more than twice its size, the regulatory framework and conditions placed on the merger, and most importantly, progress in the operating systems transition. Moody’s will also assess management’s commitment and ability to maintain an investment grade credit profile for the combined company in light of the intense competitive challenges confronting the sector and the resulting pressures to achieve the targeted cost savings...Frontier’s current Ba2 [rating] reflects the Company’s relatively high debt levels for a wireline telecommunications company and the continuing downward pressure on its revenue and cash flow.

Similarly, S&P states:

Standard & Poor's expects the integration of the Verizon properties will be challenging given the size of the transaction...we are concerned that execution missteps or deteriorating operating trends could result in higher leverage in the intermediate term...Potential operating synergies are meaningful at about \$500 million...but achieving this will require solid execution during the integration and may be impeded by higher access-line losses or a more competitive industry environment.

Given the ratings agencies' concerns regarding Frontier's ability to manage this reorganization successfully, Ms. Phipps recommended that the Commission adopt the Staff Reporting Requirement 2.

Ms. Phipps testified that potential consequences of speculative credit ratings include increasing debt costs and the inability to rollover or refinance existing indebtedness. Ms. Phipps observed that the inability to borrow funds externally reduces cash flows and available liquidity, which could cause credit ratings to spiral downward and possibly cause a company to default on one or more obligations.

To illustrate this, Ms. Phipps pointed to the example of FairPoint, which acquired certain Verizon assets and operations on March 31, 2008, in a transaction very similar to the one proposed by Joint Applicants. Ms. Phipps viewed this transaction as an example of the potential consequences of the nexus of merger integration and speculative credit ratings. Ms. Phipps noted, in seeking Commission approval of the transaction in Docket No. 07-0191, the petitioners stated that transaction would make FairPoint a financially stronger company with an improved capital structure. Moreover, Ms. Phipps observed, S&P expected the transaction to make FairPoint modestly stronger and, consequently, placed FairPoint's "BB-" rating on CreditWatch with positive implications.

Ms. Phipps pointed out that prior to the merger, FairPoint's credit ratings from Moody's, S&P and Fitch Ratings were B1/BB/BB-. In contrast, Ms. Phipps observed, slightly more than two years later, at the time she offered her direct testimony in this proceeding, FairPoint's credit ratings from Moody's, S&P and Fitch Ratings are Caa3/D/C, which signals FairPoint has defaulted or a default is imminent.

Ms. Phipps further heard Frontier to assert that:

Not only will Frontier continue to be financially strong following the closing of the proposed Verizon transaction, its financial position will be improved. By deleveraging its balance sheet and by decreasing both its per-share dividend payout and dividend payout ratio, Frontier will emerge from this transaction as a stronger, more stable competitor with a financial structure and level of cash flow that will enable it to make investments in the acquired service territories, including in broadband, and to provide even more efficient service in these areas.

Ms. Phipps noted that Frontier prepared revenue, expense, earnings before EBITDA and cash flow projections for the post-merger company through 2014, which assume \$500 million savings annually due to synergies, but did not perform any pro forma analysis assuming zero synergies. Ms. Phipps examined the sensitivity of Frontier’s financial strength to synergies Frontier assumes will occur with respect to Verizon’s Standalone Telephone Operations (“West Standalone”).

Specifically, Ms. Phipps testified that she substituted actual 2008 operating expenses and capital expenditures for West Standalone in place of Frontier’s projections for West Standalone; she did not adjust the pro forma projections for Standalone Frontier. Ms. Phipps further stated that she calculated the following pro forma financial metrics for the combined entity using Frontier’s pro forma analysis and her adjusted pro forma analysis: (1) EBITDA margin; (2) Debt to EBITDA; (3) Free cash flows (“FCF”) to debt; (4) Retained cash flows (“RCF”) to debt; (5) Funds from operations interest coverage (“FFO Interest Coverage”); and (6) EBITDA less capital expenditures (“Capex”) over interest expense. Then, Ms. Phipps noted, she compared Frontier’s pro forma and the adjusted pro forma financial metrics to Moody’s benchmarks for the global telecommunications industry. Ms. Phipps prepared the following table to illustrate Frontier’s financial metrics:

A Comparison of Frontier’s Pro Forma Financial Metrics

	Frontier Pro Forma		<i>Adjusted</i> Pro Forma	
		Implied Financial Strength		Implied Financial Strength
EBITDA Margin	48%	Aa	40%	A/Baa
Debt to EBITDA	2.8X	Baa	3.4X	Ba
FCF to Debt	13%	Baa	8%	Ba
RCF to Debt	3%	Caa	-1%	Caa
FFO Interest Coverage	3.9X	Ba	3.5X	Ba
(EBITDA – Capex) / Interest Expense	3.1X	Ba	2.3X	Ba

Ms. Phipps noted that this comparison shows Frontier’s pro forma analysis, which assumes synergies totaling \$500 million annually, produced investment grade financial metrics for three of the six ratios. In contrast, Ms Phipps’ adjustments, which removed identifiable projected synergies and assumed going forward capital expenditures will equal West Standalone’s 2008 capital expenditures, produced investment grade financial metrics for only one of the six ratios. Ms. Phipps’ analysis demonstrated that Frontier’s post-merger financial strength depends on its ability to realize a significant portion of its projected synergies. Therefore, in Ms. Phipps’ opinion, Condition 1 and Condition 2 are necessary to protect the public and Frontier.

Ms. Phipps explained that Staff Conditions 1 and 2 would ensure that the New Frontier Illinois ILECs retain sufficient funds to support Illinois operations. Ms. Phipps stated that, should the New Frontier Illinois ILECs fail to pass the service quality test

described in Staff Condition 1, those companies would be prohibited from paying dividends or otherwise transferring Illinois jurisdictional cash balances to Frontier or its affiliates through loans, advances, investments or other means that would divert its moneys, property or other resources to any purpose that is not essentially or directly connected with the provision of non-competitive telecommunication service. Frontier would continue to have access to any funds that the New Frontier Illinois ILECs generate in excess of the amount needed to meet the service quality standards.

Additionally, Staff Condition 2 would require Frontier to reserve funds, exclusively for the Illinois operations of the New Frontier ILECs, in an aggregate amount equal to the higher of \$50 million or the currently approved capital expenditure budget of the New Frontier Illinois ILECs. With this condition in place, the proposed reorganization would not significantly impair the New Frontier ILECs' ability to raise *necessary* capital on reasonable terms.

Ms. Phipps noted that Verizon's average annual capital expenditures in Illinois for years 2006 through 2008 equals approximately \$50 million. Ms. Phipps understood Frontier to anticipate spending more in capital expenditures on a nationwide basis than the historical amounts Verizon spent on the lines Frontier will acquire. On this basis, the historical amounts that Verizon spent would serve as a minimum threshold to avoid unnecessarily limiting Frontier's investment in the New Frontier Illinois ILECs.

The first part of Section 7-204(b)(4) of the Act requires the Commission to find that the proposed reorganization will not impair the utility's ability to raise necessary capital on reasonable terms. In Ms. Phipps' judgment, under the proposed reorganization, New Frontier Illinois ILECs will have little, if any need to access capital. Foremost, Ms. Phipps observed, the New Frontier Illinois ILECs currently generate sufficient cash to fund their capital expenditures budget. Furthermore, Staff Condition 1 would prevent New Frontier Illinois ILECs from transferring that cash if they fail to meet the service quality standards described in that condition; Staff Condition 2 would require Frontier to maintain a backup source of funding for New Frontier Illinois ILECs' capital expenditures through cash or credit agreements with external financial institutions.

Further, Ms. Phipps noted that Frontier expects its debt ratio to decrease from 91% to 58% following the proposed reorganization. Ms. Phipps testified that, all else equal, a lower debt to capitalization ratio signifies lower financial risk. Ms. Phipps understood Frontier to expect its weighted average cost of capital to fall to 9.13% from 9.91% following the proposed reorganization. Although Frontier and the ratings agencies speculate that the proposed reorganization will enhance Frontier's capital structure, the final capital structure of the merged entity has not yet been finalized. Therefore, Ms. Phipps recommended the Commission adopt Staff Reporting Requirement 3 that will inform the Commission of the capital structure and cost of capital following the proposed reorganization.

While the reduction in the proportion of debt in Frontier's post-merger capital structure, from its current level, should enhance Frontier's ability to raise further capital on reasonable terms should the need arise, Ms. Phipps considered it is unlikely that

Frontier will achieve the degree of financial strength necessary to raise capital on reasonable terms, under most capital market conditions, until it further reduces the proportion of debt in its capital structure.

The second part of Section 7-204(b)(4) of the Act requires the Commission to find that the proposed reorganization will not impair the utility's ability to maintain a reasonable capital structure. Ms. Phipps interpreted "reasonable capital structure" as one that permits a utility to raise capital under most market conditions and results in a reasonable overall cost of capital. Ms. Phipps noted that the New Frontier ILECs would not independently raise capital. Under that circumstance, observed Ms. Phipps, the Commission typically uses a parent company's capital structure to set rates. Ms. Phipps pointed out that the proposed reorganization would reduce the proportion of debt in Frontier's capital structure, although that reduction in debt is unlikely to be sufficient for it to attain investment grade credit ratings. From this standpoint, the proposed reorganization cannot, in Ms. Phipps' view, be deemed to result in a reasonable capital structure but can be deemed to enhance the ability of Frontier, and through Frontier, the ability of New Frontier ILECs, to achieve a reasonable capital structure.

In summary, Ms. Phipps concluded that, in her opinion, the proposed reorganization will not significantly impair New Frontier Illinois ILECs ability to raise necessary capital on reasonable terms or to maintain a reasonable capital structure, if the New Frontier ILECs comply with the Staff Conditions and Reporting Requirements.

3. Position of IBEW

IBEW argued that Joint Applicants failed to meet the requirements set forth in Section 7-204(b)(4) of the Act, whether the proposed Transaction would "significantly impair the utility's ability to raise necessary capital on reasonable terms or maintain a reasonable capital structure."

IBEW suggested that the Commission evaluate financial soundness based on a comparison of the proposed new owner with the current owner, with a particular focus on the financial impact on the Illinois operating utility. *E.g.*, Illinois Power Company and Ameren Corporation, Docket No. 04-0294. IBEW argued that, in assessing the financial strength of the proposed new owner, there are two relevant questions. First, will the new owner be financially fit by objective criteria? Second, how does the proposed new owner's financial condition compare to the present owner? IBEW argued that Frontier failed both tests. Frontier failed the first test because Frontier does not currently have an investment-grade bond rating and Frontier's revenues and net income have been in a steady state of decline. Frontier failed the second test because Frontier's financial condition is significantly weaker than Verizon's financial condition and because Frontier has regularly paid out dividends in excess of its earnings.

IBEW pointed to a 2007 Montana Public Service Commission ("PSC") decision in which the PSC rejected a proposed merger and acquisition because "In normal utility operations, retained earnings provide a vital source of financial strength for capital investment and as reserves that are available during unexpected financial strains.

Regularly paying out dividends in excess of net earnings by a utility is inappropriate and risky because having insufficient reserves on hand could adversely affect the utility's ability to provide adequate service." *NorthWestern Corp.*, 2007 Mont. PUC LEXIS 54 at ¶ 149 (Mont. PSC July 31, 2007). IBEW stated that the Montana PSC's findings apply equally to Frontier. The IBEW endorsed the reasoning of the Montana PSC and reached the same conclusion about Frontier.

According to IBEW, Frontier only has two or three more years before it will have paid out all of its retained earnings to stockholders, based on its performance in the first half of 2009. IBEW also stated that two Wall Street financial analysts have independently found that Frontier's shareholders' equity is likely to become negative in 2012 or 2013. After that, Frontier's dividend would have to be reduced to no more than its net income – a likely dividend cut of 60% or more. IBEW argued that without this Transaction, Frontier's business model will fail within two or three years. IBEW asserted that Frontier does not plan to change its approach to business. Frontier still plans to pay out more to shareholders than it earns in net income and that there is no scenario where Frontier plans to pay out less in dividends than it earns in net income during the 2010 to 2014 period examined.

IBEW contrasted Frontier's high-risk business model to Verizon. IBEW explained that Verizon has pursued a strategy of reinvesting in its landline business by upgrading to state-of-the-art fiber optic broadband service facilities (FiOS) directly to the home. FiOS has not yet reached Illinois, but IBEW contended that there is no reason to believe that urban / suburban areas of Verizon Illinois would not be in line to have these new facilities deployed. IBEW asserted that Verizon has been spending its cash on new technology and facilities that serve customers. Specifically, VSTO has been reinvesting between 77% and 96% of the cash it receives from depreciation. According to IBEW, this contrasts with Frontier's reinvestment of just 51% to 58% of its depreciation-based cash flows into new capital equipment and facilities. IBEW concluded that Verizon is a financially stronger company than Frontier.

IBEW expressed concern over the uncertainty of Frontier's financing for this Transaction. Frontier is required to issue approximately \$3.1 billion to \$3.3 billion in new debt in order to provide a cash payment (or debt exchange) to Verizon. However, Frontier has not yet obtained this debt, or even a commitment from a lender to provide the necessary financing. Therefore, the interest rate, debt service requirements, security requirements, restrictions on business operations, and other terms and conditions that Wall Street bankers will require to provide this financing to Frontier are still unknown.

IBEW also argued that the Distribution Agreement between Verizon and Frontier provides that Frontier will receive no working capital from Verizon at closing. Yet, Frontier has not explained how it will provide working capital to operate Verizon's business in Illinois and elsewhere.

IBEW argued that Frontier's assertion that its financial projections demonstrate that the proposed Transaction will improve Frontier's financial condition is questionable.

IBEW argued that Frontier's projections do not show Frontier financial condition improving to the point that the company would achieve even a minimal investment-grade bond rating, let alone a financial condition on par with Verizon's. Further, IBEW argued that Frontier's financial projections are not credible. Frontier bases its projections on overly optimistic assumptions about both revenues and expenses. Moreover, the financial projections Frontier provided in its rebuttal testimony are meaningless. IBEW asserted that Frontier has a spotty track record for projecting the financial effects of a merger.

IBEW argued that Frontier is not now and will not be a financially sound entity. Frontier's financial condition is weak. It is a company built on an unsustainable business model of consistently paying out far more to shareholders than it earns. If this Transaction is allowed to occur, Frontier's management will not change and its high-risk, unsustainable approach to business will not change, nor its desire to enrich shareholders rather than invest in new technologies and services will not change. Therefore, IBEW argued that Frontier is not financially fit to own and operate Verizon Illinois. Frontier does not have the financial wherewithal to acquire operations that would triple its size. In addition, Frontier cannot safely absorb the additional debt burden that would come with the proposed Transaction.

Finally, IBEW argued that none of the conditions proposed by Staff or intervenors and agreed to by the Joint Applicants solves the fundamental problem of Frontier's lack of financial fitness. While the Staff conditions might be a useful part of a restructured transaction, standing on their own they do not cure the problems with Frontier's financial condition. Further, IBEW argued that the proposed conditions do not contain any sanctions if Frontier fails to comply with them. Nor do the proposed conditions address what would happen if Frontier finds itself unable to make the investments it has promised to make. Similarly, proposed Staff Condition 2 requires Frontier to have a line of credit available that is at least equal to the greater of \$50 million or the Verizon Illinois annual capital budget. However, this condition does not address the cost of providing this capital to the Illinois operations and most importantly; it does not require Frontier to make any level of capital expenditures in Illinois. Thus, the proposed financial condition does not resolve the serious financial concerns this Transaction presents in this case.

4. Commission Analysis and Conclusion

The evidence presented by Joint Applicants, Staff and the Intervenors shows that the proposed reorganization will significantly impair Frontier's ability to raise the necessary capital on reasonable terms and to maintain a reasonable capital structure.

First, the Commission agrees with IBEW witness Mr. Barber that Frontier has relied upon aggressive revenue and expense assumptions to justify the transaction internally. If Frontier falls significantly short of its revenue and expense goals, it would likely come under severe pressure to reduce service-related spending, cut capital expenditures, and lower its dividend payments, or a combination of all three.

Second, it is undisputed that Frontier does not have an investment-grade bond rating. Staff witness Ms. Phipps testified that Frontier's ability to attain investment grade ratings following the proposed reorganization is questionable. Therefore, even after the proposed reorganization, Frontier's financial condition might not be sufficiently strong to eliminate concerns about its capacity to meet its debt servicing obligations during adverse conditions without transferring cash from New Frontier ILECs that is necessary for maintaining the New Frontier ILECs' service quality. Ms. Phipps further testified that Frontier's current issuer credit ratings are two rating notches below the minimum investment grade credit rating of Baa3/BBB-/BBB-. According to Moody, "[o]bligations rated Ba are judged to have speculative elements and are subject to substantial credit risk."

Frontier asserted that its credit rating is not indicative of the probability of default or any similar harm. Frontier testified that post-transaction Frontier expects to have credit statistics that are improved and are close to investment grade. While Frontier believes it will achieve an investment grade credit rating post-transaction, Frontier argued that such a rating is not required to maintain access to capital and Illinois customers will not suffer any harm based on Frontier's access to capital. Thus, Frontier argued there is no evidence or likelihood of "harm" that flows from Frontier's current or expected credit rating. The Commission disagrees with this assertion. A company's credit rating is one indication that suggests whether or not the company will have the ability to rollover or refinance existing indebtedness and whether or not the transaction may be too risky for the Commission to undertake at the expense of Illinois customers.

Ms. Phipps described the potential consequences of speculative credit ratings stating that potential consequences of speculative credit ratings include increasing debt costs and the inability to rollover or refinance existing indebtedness. The inability to borrow funds externally reduces cash flows and available liquidity, which could cause credit ratings to spiral downward and possibly cause a company to default on one or more obligations.

Although the Commission agrees with Ms. Phipps' assessment, the Commission disagrees that imposing the conditions Ms. Phipps recommended in this case cures the highly risky consequences of Frontier's speculative credit ratings.

Third, Frontier will incur an enormous amount of debt. In addition to not having an investment grade credit rating, Frontier will also be burdened with an enormous amount of approximately \$3.3 billion in debt. This is another indication that this Transaction is too risky to undertake. In the Commission's opinion, imposing the conditions presented by Staff will only further weaken Frontier's already precarious financial condition.

Fourth, Frontier's risky business model is a concern. The Commission agrees with IBEW that in normal utility operations, retained earnings provide a vital source of financial strength for capital investment and as reserves that are available during unexpected financial strains. Regularly paying out dividends in excess of net earnings

by a utility is inappropriate and risky because having insufficient reserves on hand could adversely affect the utility's ability to provide adequate service. Based on the record, this has been Frontier's business practice. However, Frontier testified that it has revised its dividend policy. According to Frontier, it currently pays an annual cash dividend of \$1.00 per share of Frontier common stock. Frontier after the closing of the proposed Transaction, intends to change its dividend policy to pay an annual cash dividend of \$0.75 per share of Frontier common stock, reducing its dividend by 25% – from \$1.00 to \$0.75 per share – effective with the close of the Transaction.

The Commission does not find Frontier's assertion credible. Specifically, that it plans to revise its dividend policy (at the discretion of its Board of Directors) because of this proposed Transaction when this has been Frontier's approach to business for years.

Lastly, Frontier has not obtained any of the debt financing it requires to complete the Transaction. Joint Applicants argued that it would be premature and imprudent for Frontier to seek terms for that debt so far ahead of closing and that the market conditions for obtaining the necessary debt is quite favorable to Frontier. Staff witness Ms. Phipps addressed this concern by recommending conditions as well as proposing reporting requirements, which will require Frontier to report the terms of its borrowing to the Commission and which will require Frontier to report its post merger capital structure. Ms. Phipps' recommendations, however, do not resolve Frontier's financial conditions and the risks it poses. In the current unstable economic environment, combined with Frontier's recent cost of debt, it is not clear that Frontier will be able to finance this Transaction on reasonable terms. These factors, among others, raise serious concerns as to Frontier's ability to raise necessary capital on reasonable terms and to maintain a reasonable capital structure.

The Commission finds it instructive that Verizon has been involved in two other divestitures, Hawaii Telecom (The Carlyle Group, "Carlyle") and FairPoint. Both divestitures have been failures, resulting in the financial failure of the acquiring companies, and a significant deterioration in customer service.

AG/CUB witness Mr. Selwin, recommended that the Commission should draw an inference from the outcomes of prior Verizon divestitures as to the potential success or failure of the one being proposed here. The Joint Applicants seek to distinguish this Transaction from the others arguing that Frontier is an experienced ILEC, that it will become the second largest ILEC in Illinois, that it is qualified, financially, managerially, and technically to manage Verizon's current Illinois operations, and that it will succeed where Carlyle and FairPoint have failed. Despite this testimony, Mr. Selwin points out, Verizon and the acquiring companies had all made similar representations as to the financial, managerial and technical qualifications of Carlyle and FairPoint when seeking approval from the Hawaii, Vermont, New Hampshire and Maine commissions for those divestitures. The proposed sale of Verizon's Illinois operations to Frontier therefore, requires careful scrutiny. The Commission agrees.

The Joint Applicants have argued unpersuasively that these two divestitures are unique within themselves. The Commission finds however, that this Transaction most closely resembles the FairPoint transaction in the risks that it presents.

On March 31, 2008, FairPoint acquired certain Verizon assets and operations in a very similar transaction to the Joint Applicants' proposed reorganization. Staff witness Ms. Phipps testified that the FairPoint / Verizon transaction is an example of the potential consequences of the nexus of merger integration and speculative credit ratings. In seeking Commission approval of the transaction, the petitioners stated that the transaction would make FairPoint a financially stronger company with an improved capital structure. Moreover, S&P expected the transaction to make FairPoint modestly stronger and, consequently, placed FairPoint's "BB " rating on CreditWatch with positive implications. Prior to the merger, FairPoint's credit ratings from S&P, Moody's and Fitch Ratings were BB/B1/BB-. Today, FairPoint's credit ratings from S&P, Moody's and Fitch Ratings are D/Caa3/C, which signals Fairpoint has defaulted or a default is imminent.

The Commission finds that the record evidence raises serious doubts as to Frontier's qualifications to step into Verizon's shoes as the second largest ILEC in Illinois, given the enormous problems and disruptions that resulted from these two recent Verizon ILEC divestitures. The minimal benefits to Illinois customers if any, is not worth the substantial risks to which customers would be exposed. Thus, the risk level is so great that it warrants rejection outright.

The Commission is authorized to impose such terms, conditions, or requirements as, in its judgment are necessary to protect the interests of the public utility and its customers. The Commission is of the opinion that this case is not the typical reorganization case where conditions and terms have been appropriately imposed. The present reorganization case is different from any other the Commission has seen and therefore should be treated as such.

Frontier serves approximately 97,000 access lines in Illinois. Verizon serves approximately 573,000 access lines in Illinois. Frontier's total Illinois access lines would be increasing from 97,000 Illinois to over 670,000 lines. If this reorganization were to be approved, Frontier would be almost tripling its size and would be burdened with an enormous amount of approximately \$3.3 billion in debt. Frontier, nor any other company its size, has ever taken on a deal of this complexity and magnitude requiring the integration of 4.8 million lines spread over parts of 14 states stretching from coast to coast. Because of these major differences from other reorganization cases, the Commission finds that the proposed conditions are inadequate to protect the public from the substantial harms that are likely to arise from the proposed Transaction. Illinois customers demand stability and certainty in their public utility service. Approving this reorganization (even with conditions) would be going against the grain of that stability and certainty. Therefore, the Commission rejects all of Staff and intervenors condition recommendations as inadequate to protect Illinois customers and against the public interest.

The Commission rejects Joint Applicants assertion that this transaction without conditions satisfies the requirement pursuant to Section 7-204(b)(4) of the Act. The Commission also rejects Staff's assertion that with conditions the proposed reorganization satisfies the requirement.

The Commission therefore finds that the evidence presented by Joint Applicants, Staff, IBEW, and the AG/CUB shows that the proposed reorganization will significantly impair Frontier's ability to raise necessary capital on reasonable terms and to maintain a reasonable capital structure.

D. Section 7-204(b)(5) of the Act provides that “the utility will remain subject to all applicable laws, regulations, rules, decisions and policies governing the regulation.”

1. Position of Joint Applicants

Section 7-204(b)(5) of the Act states that, in approving a proposed reorganization, the Commission must find that “the utility will remain subject to all applicable laws, regulations, rules, decisions and policies governing the regulation” of Illinois incumbent local exchange carriers. According to Joint Applicants, no element of this Transaction will impact the applicability of Illinois law to the utilities at issue. The Verizon North exchanges in Illinois will remain the Verizon North exchanges in Illinois, albeit under a different name. The Verizon South exchanges in Illinois, although their assets will be transferred from one corporate entity to another, will remain subject to Illinois law. Likewise, all of the Frontier ILECs will remain subject to all applicable laws, regulations, rules, decisions and policies governing the regulation of telephone service.

Staff witness Dr. Qin Liu testified that Verizon South is technically out of compliance with Section 13-517 of the Act, related to minimum coverage for advanced services (an assertion that Verizon has contested). Dr. Liu proposed the first paragraph of Staff Condition 6 to address that concern. Frontier not only agreed to the first paragraph of Staff Condition 6, but, in order to address concerns about broadband deployment raised by Staff and others, added the commitment included in the second paragraph of Staff Condition 6, committing to roll out a higher level of broadband service on a broader basis than is required by Illinois statute throughout the New Frontier Illinois ILEC territories. Frontier's broadband commitment is further underscored by its agreement to AG/CUB Conditions 6-8, which will give Staff as well as the AG and CUB a voice in the development of a broadband roll out strategy and help them monitor its progress.

In addition, Frontier reached a stipulated settlement agreement with IPTA under which Frontier agreed that the Commission's Final Order, if approved should include a provision that, so long as the Commission's Final Order in Docket No. 98-0195 (relating to pricing and services available to pay telephone operators) remains in effect, the Final Order will be binding on Verizon North and NewILEC. Frontier further agreed to support

a provision being added to the Commission's Final Order in this docket stating that the current rates, terms and conditions for local exchange services provided by Verizon North and Verizon South to payphone service providers shall remain in effect in the Verizon North and NewILEC territories for three years after the closing of the proposed Transaction.

Frontier acknowledged the continuing applicability of Illinois law. Thus, according to Joint Applicants the proposed reorganization meets the criteria of Section 7-204(b)(5) of the Act.

2. Position of Staff

Dr. Liu offered testimony regarding Staff's assessment of whether the proposed Transaction satisfies Section 7-204(b)(5) of the Act. The two ILECs involved in the proposed merger, Verizon North and Verizon South, would remain ILECs in their respective service territories. All the applicable laws, rules and regulations governing the two incumbent local exchange companies will not change as a result of the merger, including, but not limited to, Section 251 of the 1996 Telecommunications Act.

Dr. Liu understood Frontier to pledge to "assume and honor all obligations under Verizon's current interconnection agreements, wholesale tariffs, and other existing wholesale arrangements in addition to complying with the statutory obligations applicable to all LECS." Without committing to a specific freeze period, however, Frontier's commitment to assume Verizon's wholesale obligations and provide continuous, uninterrupted service may not, in Dr. Liu's opinion, be meaningful in practice. Therefore, Dr. Liu recommended a specific freeze period to ensure that Frontier provide continuous, uninterrupted services to its wholesale customers after the merger closing.

Dr. Liu recommended a three-year freeze period, which is in line with the practice of mergers in other states. Frontier has since negotiated agreements with Comcast and Level 3, in which different freeze periods were imposed on different classes of wholesale customers. For example, the freeze period for interconnecting customers is 30 months. For wholesale customers that purchase services from Verizon through tariffs (such as special access tariff or intrastate wholesale tariff), the freeze period is 24 months. Dr. Liu ultimately agreed to Frontier's revised proposal of 30 month freeze period for all wholesale customers.

In addition, Dr. Liu noted that the General Assembly has imposed a number of requirements on ILECs, including that of providing advanced telecommunications services to customers in Illinois. Specifically, "[e]very Incumbent Local Exchange Carrier (telecommunications carrier that offers or provides a noncompetitive telecommunications service) shall offer or provide advanced telecommunications services to not less than 80% of its customers by January 1, 2005." Based on information provided in this proceeding, Dr. Liu stated that Verizon South is currently not in compliance with Section 13-517 of the Act. Dr. Liu recommended that Frontier bring

Verizon South into compliance with Section 13-517 of the Act within 24 months of the merger closing date.

3. Commission Analysis and Conclusion

The Commission is unclear how long Verizon South has been in non-compliance with Section 13-517 of the Act, which, as described by Staff witness Dr. Liu requires Illinois local exchange carriers to make “advanced services” available to at least 80% of its customers. Frontier witness Mr. McCarthy asserted that Frontier intends to meet the requirements of Section 13-517 of the Act within 24 months. Mr. McCarthy also committed to roll out a higher level of broadband service on a broader basis than is required by Illinois statute.

The Commission is not confident that Frontier will be able to meet this commitment of compliance within 24 months in addition to rolling out a higher level of broadband service. Verizon South, a stronger company with more resources has yet to meet compliance. The Commission is also of the opinion that Verizon South should not be allowed to walk away from its legal obligation and leave the non-compliant territory in the hands of Frontier.

Having reviewed the evidence presented, the Commission finds that Joint Applicants do not meet the requirements of Section 7-204(b)(5) of the Act due to the non-compliance of Verizon South with Section 13-517 of the Act, which was discovered during the course of the instant proceeding. The Commission hereby orders Staff to conduct an investigation into Verizon South's non-compliance of Section 13-517 of the Act.

E. Section 7-204(b)(6) of the Act provides that “the proposed reorganization is not likely to have a significant adverse impact on competition in those markets over which the Commission has jurisdiction.”

1. Position of Joint Applicants

Joint Applicants contended that the proposed reorganization also satisfies the requirement of Section 7-204(b)(6) of the Act, which requires a Commission finding that “the proposed reorganization is not likely to have a significant adverse impact on competition in those markets over which the Commission has jurisdiction.” According to the Joint Applicants nothing in the proposed reorganization will result in adverse impacts on competition in the Illinois telecommunications markets. First, none of the Verizon North or Verizon South ILEC local exchanges being acquired by Frontier overlap with any of the local exchanges already served by the Frontier ILECs. The Frontier and Verizon ILECs do not currently compete for customers in any of the affected exchanges. While Verizon does have wireless service in the Frontier territories, Verizon will not be transferring its wireless business and will continue to compete with Frontier in both Frontier’s existing and its new territories. Similarly, both Verizon and Frontier will compete for the enterprise business customers that Verizon currently serves (many or

which it will continue to serve) in the New Frontier Illinois ILEC territories. According to the Joint Applicants, the Transaction will not reduce the number of competitors in Illinois and, in fact, will increase competition.

Further, the proposed Transaction will not have any adverse impacts on wholesale service customers in Illinois. Staff witness Liu proposed in Staff Condition 5 that wholesale rates be capped for a period of time following closing on the proposed Transaction. Frontier agreed to ensure stability for wholesale customers through settlements with Comcast and Level 3, two of its largest and most sophisticated wholesale customers, and through Condition 5.

AG/CUB conditions 15-21 will provide further stability to wholesale customers of the New Frontier Illinois ILECs by assuring that Staff, as well as the AG and CUB are kept apprised of OSS changes within Frontier that could have customer impacts.

2. Position of Staff

Dr. Liu also offered Staff's assessment of whether the proposed Transaction satisfies Section 7-204(b)(6) of the Act.

Dr. Liu stated that merger *generally* reduces the number of competitors in the market. Dr. Liu noted that this would theoretically reduce the degree of competition and raise the retail prices of the goods or services, thus having an adverse impact on competition. However, observed Dr. Liu, this does not apply in this proposed merger. Dr. Liu pointed out that Frontier currently owns ten local exchange companies in Illinois, nine of which are ILECs. Based on information provided by Joint Applicants, none of the nine ILECs currently operate in any of the local exchanges where Verizon North or Verizon South is currently operating as an ILEC. In addition to the nine ILECs, Frontier also owns Frontier Communications of America, which sought, and was granted, an authority to operate as a facilities-based local exchange carrier within the exchange areas of Frontier's nine ILECs in Docket No. 07-0233. Frontier's competitive local exchange carrier, Frontier Communications of America, has not filed a local exchange tariff with the Commission as of this date. This means that it has not started offering local exchange services pursuant to authority granted in Docket No. 07-0233.

Moreover, the approved service territory for Frontier's CLEC is identical to those of its nine ILECs. Thus, Frontier's service territories granted by the Commission currently do not overlap with those of Verizon North and Verizon South. As a result, Frontier is not in direct competition with the Verizon North and Verizon South, the two ILECs involved in the proposed reorganization. Therefore, it was Dr. Liu's opinion that the proposed reorganization will not change the number of competitors for local exchange services in any of the local exchanges involved, and thus would not have a significant adverse impact on competition in the affected local exchanges.

3. Commission Analysis and Conclusion

The Commission finds that the evidence presented by Joint Applicants and Staff demonstrates that the proposed reorganization satisfies the requirement of Section 7-204(b)(6) of the Act and that the proposed reorganization is not likely to have a significant adverse effect on competition in those markets over which the Commission has jurisdiction.

F. Section 7-204(b)(7) of the Act provides that “the proposed reorganization is not likely to result in any adverse rate impacts on retail customers.”

1. Position of Joint Applicants

Section 7-204(b)(7) of the Act states that in approving a proposed reorganization, the Commission must find that “the proposed reorganization is not likely to result in any adverse rate impacts on retail customers.” Joint Applicants testified that, for the Verizon North exchanges, the very same Verizon tariffs that currently apply to those retail customers before the Transaction will apply after. For the Verizon South exchanges, the same Verizon tariffs that currently apply to those retail customers before the Transaction will be submitted for Frontier Communications of the Carolinas Inc. and will apply to those exchanges after the closing of the proposed Transaction. No existing regulated intrastate service will be discontinued or interrupted as a result of the proposed Transaction. Through proposed Condition 7, Staff witness Karen Chang proposed to ensure that those charges, as applied to non-competitive services, remain capped for at least three years after closing, to which Frontier agreed. As a result of Condition 7, those non-competitive, retail rate caps will stay in place for three years.

Similarly, the AG and CUB proposed conditions 9-14 which Frontier agreed will give further assurances to retail customer that they will not see unjustified rate increases, that the service bundles they are use to will not be abandoned as a result of this Transaction, and services currently deemed non-competitive will not be declared competitive and become subject to market-based price increases.

Frontier, in short, will offer essentially the same regulated intrastate retail services as Verizon’s customers receive today. Over time Frontier intends to offer customers new service choices that are currently available to Frontier’s existing customers, as well as new products, promotions and services Frontier may make available in the future. Thus, according to the Joint Applicants the proposed reorganization meets the criteria of Section 7-204(b)(7) of the Act.

2. Position of Staff

Karen Y. Chang offered Staff’s assessment of whether the Transaction satisfies Section 7-204(b)(7) of the Act. Frontier witness Mr. McCarthy testified that the “very same ... tariffs that currently apply to ... retail customers” before the Transaction will apply after the proposed reorganization is closed for all the Verizon North and South

exchanges, and Frontier claimed to “ha[ve] no plans to change any of those [regulated intrastate] rates at the time Staff filed its Direct Testimony.” Ms. Chang viewed this assurance as inadequate for two reasons. First, Ms. Chang observed that Frontier had not, prior to the Transaction, conducted any analysis to determine whether it could continue to charge Verizon’s current rates, or more pointedly, whether any changes to operations resulting from the reorganization would cause Frontier to seek an increase in rates. Second, Ms. Chang noted that, at the closing of this Transaction, Frontier would inherit the books, records and rates of Verizon. Ms. Chang pointed out that Verizon is a rate of return company regulated primarily under Article IX of the Act, and its rates were set in its last rate filing in 1994. These matters, Ms. Chang stated, were of particular concern in light of the fact that, as a result of significant changes in communications technology, law and regulation that have taken place in the intervening fifteen-plus years since Verizon (then General Telephone, or GTE) sought a rate increase, the existing Verizon rate structure may be such as to cause Frontier to seek retail rate increases over the short term. In particular, Ms. Chang cited line losses experienced by Verizon in recent years, as well as the possibility that Frontier will incur costs in merging of billing and operational systems as likely causes for a Frontier decision to seek increased rates.

Based on this, Ms. Chang recommended a freeze in competitive and noncompetitive services for three years after the closing of the Transaction. She also recommended that the Commission require Frontier to present a rate case in order to make any noncompetitive rate increases after the three year freeze.

In response to Ms. Chang’s opinion, Frontier witness Mr. McCarthy stated that the company was generally concerned about the three year duration of Ms. Chang’s proposed rate freeze. Mr. McCarthy opined that a cap on regulated non-competitive retail rates for one year after closing of the proposed Transaction would be sufficient. Mr. McCarthy stated that Frontier did not believe it would be in the best interest of its customers to “freeze” rates where continued competition from both CLECs (including cable telephone providers) and wireless companies places downward pressure on all pricing. Mr. McCarthy testified that Frontier also sought acknowledgement in the Commission’s Final Order that Frontier could seek relief from this condition if the FCC or Congress takes any action that significantly impacts carrier rate design, for example, through significant changes to intercarrier compensation.

In her rebuttal testimony, Ms. Chang continued to advocate a three year cap on all regulated rates. Because first, this would assure that there is no adverse impact on ratepayers as a result of the reorganization. Second, in Ms. Chang’s opinion, savings are unlikely to be reflected in Frontier’s books until three years have elapsed. Third, Ms. Chang opined that Frontier will most probably spend three years preparing a rate case for the new, larger company to be presented to the Commission.

Ms. Chang recommended that Frontier be allowed to increase its rates only upon a rate case presented by Frontier anytime following the closing. In addition, Ms. Chang testified that she had no objection to Frontier being allowed to seek relief from this

condition if the FCC or Congress takes any action that significantly impacts carrier rate design.

In his surrebuttal testimony, Mr. McCarthy stated that, if competitive services are excluded from the rate cap, Frontier was prepared to accept the condition as part of an approval. Mr. McCarthy offered as his opinion that competitive services are offered in competition with other carriers, and a cap on these rates could require Verizon to offer them at a rate below cost or below an appropriate return on investment, which could distort the market for such services. Mr. McCarthy stated that Frontier was prepared to cap all regulated noncompetitive retail rates for the former Verizon operating companies for three years from the date of closing of the proposed Transaction. After three years, Mr. McCarthy stated, Frontier would be obliged to present a rate case in order to make any noncompetitive rate increases.

Staff understood that Frontier acceded to, and Staff recommended the Commission impose Staff Condition 7.

3. Commission Analysis and Conclusion

For the reasons set forth above in the description of the evidence presented by Joint Applicants and Staff, the Commission finds that the proposed reorganization is not likely to result in any adverse rate impacts on retail customers and therefore satisfies the requirement of Section 7-204(b)(7) of the Act.

- G. Section 7-204(c) of the Act provides that the Commission shall not approve a proposed reorganization without ruling on: (i) the allocation of savings from the proposed reorganization; and (ii) whether the company should be allowed to recover any costs incurred in accomplishing the proposed reorganization and, if so, the amount of costs eligible for recovery and how the costs will be allocated.**

1. Position of Joint Applicants

Section 7-204(c) of the Act states that the Commission shall not approve a proposed reorganization without ruling on: (i) the allocation of savings from the proposed reorganization; and (ii) whether the company should be allowed to recover any costs incurred in accomplishing the proposed reorganization and, if so, the amount of costs eligible for recovery and how the costs will be allocated.

Although Frontier believed there may be future synergies and resulting savings in the future due to the reorganization, savings on an Illinois-specific basis have not been determined and the timing and actual amount of any such savings in Illinois would be speculative. Additionally, any such savings will likely be offset by expenses incurred to achieve them and associated with upgrading the network facilities to be acquired. Frontier currently intends to expand broadband availability over time, and any direction

by the Commission requiring Frontier to redirect savings elsewhere would detract from broadband investment in Illinois.

Frontier agreed to not to seek in this proceeding or any other proceeding to recover costs Frontier may incur in accomplishing the proposed reorganization.

2. Position of Staff

Mr. Ostrander presented Staff's analysis regarding Section 7-204(c) of the Act. Mr. Ostrander understood Mr. McCarthy to testify that savings on an Illinois-specific basis have not been determined and that any such savings will likely be offset by expenses incurred to achieve the savings and associated with upgrading the network facilities to be acquired, and to further testify that the Joint Applicants are not seeking in this proceeding, nor will they seek in any other proceeding, to recover any costs Frontier may incur in accomplishing the proposed reorganization. Mr. Ostrander recommended that the Commission determine that: (1) the allocation of any savings resulting from the proposed reorganization would flow through to the costs associated with the regulated intrastate operations for consideration in setting rates by the Commission; and (2) the Joint Applicants will not be allowed to recover any costs incurred in accomplishing the proposed reorganization in future rate proceedings.

Regarding compliance with Section 7-204(c) of the Act, Mr. Ostrander recommended that the Commission rule that:

- 1) The allocation of any savings resulting from the proposed reorganization would flow through to the costs associated with the regulated intrastate operations for consideration in setting rates by the Commission; and
- 2) Joint Applicants will not be allowed to recover any costs incurred in accomplishing the proposed reorganization in future rate proceedings.

In his rebuttal testimony, Mr. McCarthy concurred with Staff's position on Section 7-204(c) of the Act, in that Joint Applicants will allocate any savings resulting from the proposed reorganization to the costs associated with the regulated intrastate operations for consideration in setting rates by the Commission, and that Joint Applicants will not be allowed to recover any costs incurred in accomplishing the proposed reorganization in future rate proceedings.

3. Commission Analysis and Conclusion

Under Section 7-204(c) of the Act, before approving a utility reorganization, the Commission must rule on: "(i) the allocation of any savings resulting from the proposed reorganization; and (ii) whether the companies should be allowed to recover any costs incurred in accomplishing the proposed reorganization, and if so, the amount of costs eligible for recovery and how the costs will be allocated."

The Commission however does not need to address Section 7-204(c) of the Act because the Commission has found that this reorganization should not be approved.

V. RECOMMENDATIONS REGARDING OTHER SECTIONS OF THE ACT

A. Section 13-900 of the Act

Stacy Ross presented Staff's assessment of compliance with Section 13-900 of the Act. Staff initially sought assurances that, subsequent to the closing of the Transaction, Frontier will have the appropriate systems, personnel and expertise to maintain and operate the 9-1-1 system in Illinois. Mr. McCarthy stated Frontier understands that the 9-1-1 service and E9-1-1 service that Verizon currently provides in Illinois is a critical safety issue to the people of Illinois and of utmost concern to the Commission. Similarly, Mr. McCarthy stated that Frontier views the seamless transfer of that service from Verizon to Frontier as a critical element of this Transaction. In general, the Joint Applicants' witnesses represented that all of the 9-1-1 services and functions that are currently being performed by Verizon will continue to be performed after the Transaction by Frontier. In addition, the employees who operate and support Verizon's existing 9-1-1 systems will continue to do so after the Transaction as employees of Frontier.

Ms. Ross stated that she was also concerned with the applicability of Section 13-900 of the Act, with regard to Frontier/Verizon North and New Communications of the Carolinas/Verizon South. Section 13-900 of the Act requires 9-1-1 a service provider that was not providing 9-1-1 service on June 30, 2009, to obtain a Certificate of 9-1-1 Service Provider Authority if it plans to provide 9-1-1 network and database services to an authorized 9-1-1 system.

Since Verizon North was providing 9-1-1 network and 9-1-1 database service on the effective date of June 30, 2009, and since Frontier is, under the terms of the agreement, purchasing Verizon North outright, Staff's position is that the Verizon North properties transferred to Frontier should be exempt from the certification requirement under this provision. When the Transaction closes, Verizon North will continue to operate under all of its current certificates of authority with nothing more than a name change to Frontier. Since Verizon North was providing 9-1-1 network and 9-1-1 database service on the effective date of June 30, 2009, it should be exempt from the certification requirement under this provision.

The case is different for Verizon South properties which will be taken over by a newly-formed ILEC named New Communications of the Carolinas, which was not providing 9-1-1 network and 9-1-1 database service on June 30, 2009. It appears, therefore, that New Communications of the Carolinas is not exempt from the Section 13-900 of the Act certification requirement.

However, as noted above, Joint Applicants' witnesses testified that Verizon employees responsible for the operation of the current Verizon 9-1-1 system in Illinois

will be transferred to Frontier at closing. In addition, Frontier intends to open a new 9-1-1 customer care center to serve states, including Illinois, where it is acquiring properties from Verizon. Any necessary additional training of the existing workforce that supports 9-1-1 services in Illinois will be conducted by Verizon prior to closing. Frontier witnesses testified that Frontier has demonstrated that it has the financial capabilities and resources to meet the statutory requirements for a 9-1-1 Certificate and has requested that the Commission grant it a Certificate of 9-1-1 System Provider Authority in this proceeding.

In light of these factors, it was Ms. Ross' opinion that New Communications of the Carolinas will, upon closing of the Transaction, possess the necessary technical and managerial resources and abilities to meet the requirements of Section 13-900(c) of the Act. Staff also agreed that Frontier demonstrated sufficient financial capabilities and resources throughout its testimony in this proceeding. In conclusion, based on representations made by Mr. McCarthy in his rebuttal testimony, New Communications of the Carolinas will, when it comes into existence, possess sufficient technical, financial and managerial resources and abilities to provide network service and database services in a safe, continuous, and uninterrupted manner as required by Section 13-900(c) of the Act. Therefore, Ms. Ross recommended that the Commission grant New Communications of the Carolinas a Certificate of 9-1-1 System Provider Authority.

At the time Ms. Ross filed her testimony, it did not appear that approving the reorganization would negatively impact the delivery of 9-1-1 services in Illinois. Ms. Ross recommended that the following conditions be imposed:

- The post-merger company must inform the Commission prior to the reduction or removal of any 9-1-1 staff which are functional in providing 9-1-1 services in Illinois.
- Any post-merger operational changes that are made in the delivery of 9-1-1 services must be transparent to the 9-1-1 systems, as well as to the 9-1-1 subscribers.
- Any rate increase requested specifically for 9-1-1 network and services should not create additional profits for the post-merged company and shall be submitted to normal Commission review of proposed increases.

Frontier acceded to the imposition of these conditions by the Commission.

B. Section 6-103 of the Act

Ms. Phipps presented Staff's analysis of this issue. She stated that the capitalization of a public utility formed by a merger or consolidation of two or more corporations is subject to Commission approval under Section 6-103 of the Act. Ms. Phipps recommended the Joint Applicants provide the Commission sufficient information to make a determination regarding the post-merger capitalization, as

required under Section 6-103 of the Act. Since the final capital structure of the merged entity has not yet been finalized, Ms. Phipps recommended the Commission adopt Reporting Requirement 3, which will require Frontier to inform the Commission of the capital structure and cost of capital following the proposed reorganization, to which Frontier acceded.

VI. POSITION OF INTERVENORS: COMCAST, LEVEL 3, IPTA, DOD-FEA AND AG/CUB

Intervenors Comcast, Level 3, IPTA, DoD-FEA and the AG and CUB each reached agreed settlements and/or stipulations with Joint Applicants resolving the concerns of each of these intervenors with the proposed Transaction.

A. Comcast and Level 3

On the basis of the settlement agreements included in the record as Frontier Exhibits 8.1 and 8.2; neither Comcast nor Level 3 had any objection to the Commission approving the proposed Transaction.

B. DoD-FEA

According to DoD-FEA, it reached a resolution of all of its issues with Joint Applicants and, subject only to the inclusion of DoD-FEA's condition in a Final Order in this docket, DoD-FEA supports the proposed Transaction and urges the Commission to approve the Joint Application in all respects.

The condition proposes that for a minimum period of three years after the close of the Transaction, the New Frontier Illinois ILECs shall cap the rates for Retail Flat and Measured Rate Business Services (1FB and 1MB), and PBX, Centrex, and interstate and intrastate special access services, at their levels in effect at the close of the Transaction. The New Frontier Illinois ILECs may petition the Commission to seek recovery from the impact of exogenous events that materially impact the operations of the New Frontier Illinois ILECs, including but not limited to, orders of the FCC and the Commission (such as a generic intrastate access proceeding); DoD-FEA may file to participate in the Commission's consideration of such a petition by Frontier.

C. AG/CUB

AG/CUB offered the direct and rebuttal testimony of Lee L. Selwyn. Dr. Selwyn testified that continued availability of high quality, reliable local wireline telephone service is essential for Illinois consumers and for the Illinois economy generally. He expressed concern about the size of the Transaction, Frontier's financial condition and the financial burdens associated with the Transaction, the transition from Verizon to Frontier's operating support systems and its effect on service quality and local operations, and Frontier's ability to expand Digital Subscriber Line ("DSL") in the territory it is purchasing.

After the close of evidentiary hearings, AG/CUB submitted a Stipulation with the Joint Applicants containing a group of conditions to resolve all issues among the parties and to expedite the orderly disposition of this proceeding. As stated in the Stipulation, AG/CUB do not oppose the proposed Transaction subject to: (1) the conditions to the Stipulation between AG/CUB and the Joint Applicants; (2) the conditions enumerated in Frontier Corrected Exhibit 8.4.A; and (3) the conditions in Frontier Exhibit 8.1. Based on their settlements or stipulations and/or the inclusion of their conditions, each of these intervenors do not oppose the proposed Transaction.

D. IPTA

The IPTA submitted the prefiled direct and rebuttal testimonies of Mark Shmikler. In response to the IPTA's direct testimony, Frontier submitted the rebuttal testimony of Mr. McCarthy, in which Frontier noted that the IPTA sought assurance that, if the proposed reorganization were approved, Frontier would continue to meet the existing obligations of Verizon North and Verizon South to payphone service providers pursuant to the Commission's existing orders. Frontier witness Mr. McCarthy stated that Frontier would agree to meet Verizon North's and Verizon South's current obligations under the applicable Commission rules for payphones in the current Verizon exchanges. As a result, the IPTA and Frontier entered into discussions resulting in an agreement whereby the parties entered into a joint Stipulation that was submitted with the surrebuttal testimony of Mr. McCarthy as Frontier Exhibit 8.3. Pursuant to the Stipulation, the IPTA did not submit its prefiled testimonies into the record.

The Stipulation provides that the parties agree to the Commission providing in the Final Order provisions that as long as the Commission's Final Order in Docket No. 98-0195 remains in effect, it will be binding on Verizon North and NewLLEC in the provision of local exchange services to payphone service providers in the current Verizon North and Verizon South local exchange territories, and that the current rates, terms and conditions for local exchange services provided by Verizon North and Verizon South shall remain in effect in the Verizon North and NewLLEC territories for three years after the closing of the proposed Transaction.

Subject to the inclusion of such provisions in the Final Order, the IPTA has no objection to the Commission's approval of the proposed Transaction.

VII. CONCLUSION

Based on the review of the Joint Application and the testimony of Joint Applicants, Staff, AG/CUB, DoD-FEA and IBEW, the Commission concludes that the proposed reorganization will adversely affect Frontier's ability to perform its duties under Section 7-204 of the Act, in that the proposed reorganization will diminish Frontier's ability to provide adequate, reliable, efficient, safe and least-cost public utility service; and will significantly impair Frontier's ability to raise necessary capital on reasonable terms and to maintain a reasonable capital structure; and due to the non-compliance of Section 13-517 of the Act, the proposed reorganization fails to meet the standard of Section 7-204(b)(5). Accordingly, the proposed reorganization must not be approved.

The Joint Application requests other regulatory relief pursuant to Sections 13-405 and 13-406 of the Act; however, because the Commission is denying the application and rejecting the reorganization these sections are therefore inapplicable.

VIII. FINDINGS AND ORDERING PARAGRAPH

The Commission, having considered the entire record herein and being fully advised in the premises, is of the opinion and finds that:

- (1) Frontier Communications Corporation, and Verizon Communications, Inc., Verizon North, Inc. and Verizon South, Inc., are each telecommunications carriers as defined in Section 13-202 of the Act, and is providing telecommunications services as defined in Sections 13-203 and 13-204 of the Act;
- (2) the Commission has jurisdiction over the parties hereto and the subject matter thereof;
- (3) the recitals of fact and conclusions of law reached in the prefatory portion of this Final Order are supported by the evidence and are hereby adopted as findings of fact and conclusions of law;
- (4) for the reasons set forth in the prefatory portion of this Final Order, the proposed reorganization will adversely affect Frontier's ability to perform its duties under the Act and the proposed reorganization fails to meet the criteria as set forth in Section 7-204 of the Act in that:
 - a. the proposed reorganization will diminish Frontier's ability to provide adequate, reliable, efficient, safe and least-cost public utility service;
 - b. the proposed reorganization will significantly impair Frontier's ability to raise necessary capital on reasonable terms and to maintain a reasonable capital structure;
 - c. the proposed reorganization fails to meet the standard that the utility will remain subject to all applicable laws, regulations, rules, decisions, and policies governing the regulation of Illinois public utilities;
- (5) having found that Joint Applicants' proposed reorganization fails to meet the criteria as set forth in Section 7-204 of the Act, the relief requested under Sections 13-405 and 13-406 of the Act are inapplicable and therefore denied in a manner consistent with the ultimate conclusions reached herein;

- (6) having found that Joint Applicants proposed reorganization fails to meet the criteria as set forth in Section 7-204 of the Act, the relief requested for Eligible Telecommunications Carrier Status is inapplicable and therefore denied in a manner consistent with the ultimate conclusions reached herein;
- (7) Staff should conduct an investigation into Verizon South's non-compliance with Section 13-517 of the Act;
- (8) the prayer of the Joint Applicants is therefore denied, as against the public interest;
- (9) all motions or objections which have not been ruled upon should be deemed disposed of in a manner consistent with the ultimate conclusions in this Final Order.

IT IS THEREFORE ORDERED by the Illinois Commerce Commission that the Joint Application for approval of a reorganization pursuant to Section 7-204 of Act and other requested relief under sections 13-405 and 13-406 of the Act, and Eligible Telecommunications Carrier Status is hereby denied.

IT IS FURTHER ORDERED that Staff conduct an investigation into Verizon South's non-compliance with Section 13-517 of the Act.

IT IS FURTHER ORDERED that any objections, motions, or petitions not yet ruled upon are hereby deemed disposed of in a manner consistent with the ultimate conclusions reached herein.

IT IS FURTHER ORDERED that subject to the provisions of Section 10-113 of the Public Utilities Act and 83 Ill. Adm. Code 200.880, this Order is final; it is not subject to the Administrative Review Law.

Dated: March 9, 2010

Briefs on Exceptions Due: March 19, 2010
Replies on Briefs Due: March 25, 2010

Lisa M. Tapia
Administrative Law Judge