



National Regulatory
Research Institute

**A New Era in ILEC Transfers:
Safeguarding Wireline Telecom Service**

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

Online Access

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

From the Executive Director

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

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

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

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

Scott Hempling, Esq.
Executive Director
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Executive Summary

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

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

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

- In the type of transaction contemplated by Verizon and Frontier, how and to what extent do the private interests of the transferor and transferee diverge from the public interest, and what is the responsible role for regulation when private behavior diverges from the public interest?
- What are the substantive areas requiring regulatory alertness (during ownership transition; and during the short- and long-term, post-transition)?
- In reviewing these transactions, what are effective processes by which regulators can create the factual record necessary to serve the public interest?
- What are the commission's options if a proposed transfer raises public interest concerns?

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

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

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

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

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

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

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

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

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A New Era in ILEC Transfers: Safeguarding Wireline Telecom Services

I. Introduction

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

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

In the current paper, we apply this framework to the regulatory review of another specific type of transfer of control. This paper focuses on the recent transfers of control of wireline local exchange and intrastate telecommunications businesses by a large, highly integrated national ILEC² to new owners who have direct experience in the business they seek to acquire, but on a very much smaller scale and scope.

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

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

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

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

- Large blocks of exchanges—in some cases the entirety of the parent company’s operations in a state—are being transferred; thus, the consequences of not getting it right will have a broader geographic and economic impact than for transactions involving a small number of isolated communities.
- The buyer is considerably smaller, in terms of size, scope, financial strength, and managerial experience, than the seller.
- In some cases, the specific assets, customers, services, and even geographic markets that are proposed to be divested exclude the highest-margin, highest-revenue, and fastest-growing components of the (pre-divestiture) ILEC’s operations, thereby diminishing the purchaser’s revenue, profit, and growth opportunities as soon as the transaction closes.
- The transactions frequently involve a significant increase in overall leverage (i.e., debt-to-equity ratio) on the part of the purchaser, often requiring commitments to large new debt financing and debt service, such that the post-transaction purchaser will be in a substantially weaker financial condition with respect to the exchanges being purchased than the seller had been with respect to those same assets.

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

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

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

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

Table 1		
Summary Financial and Operational Data		
(Data Pro-forma for Year End 2008)		
	Pre-Acquisition Frontier	Post-Acquisition Frontier Pro-Forma
Access Lines	2.25 million	7.05 million
States	24	27
States with more than 500,000 lines in service	1	7
Employees	5,671	16,000
Revenue	\$2.25 billion	\$6.52 billion
EBITDA	\$1.20 billion	\$3.125 billion*
“Free Cash”	\$493 million	\$1.43 billion*
CAPEX	\$290 million	\$700 million
Net Debt	\$4.55 billion	\$8.00 billion
Dividend / Share	\$1.00	\$0.75
Shares Outstanding	312 million	989 million
Net Leverage (Debt vs EBITDA)	3.8x	2.6x
Equity Value	\$2.42 billion	\$7.67 billion
* Does not include estimated “synergy” cost savings of \$500 million. SOURCE: “Welcome to the New Frontier” Slide Presentation dated May 13, 2009, available at the Frontier Communications Website, Investor Relations page, http://phx.corporate-ir.net/phoenix.zhtml?c=66508&p=irol-irhome		

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

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

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

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

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

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

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

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

A. Elements of the public interest

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

B. Private interests associated with the sale of wireline franchises

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

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

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

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

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

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

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

III. Substantive Areas Requiring Regulatory Alertness

A. Is the regulatory authority sufficient?

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

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

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

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

requiring prior authorization by utility regulators for corporate reorganizations,¹⁵ including mergers, that result in a transfer of control¹⁶ or ownership of the utility; or for the sale or other transfer of a utility franchise.¹⁷ Many states regulate both entry¹⁸ of telecommunications companies and any discontinuation of service.¹⁹ In fact, decisions that affect the financial stability of telephone companies may be subject to review even outside of a transfer of control or entry situation.²⁰

Does the state’s regulatory framework, as applied to this type of transaction, provide jurisdiction over the seller, the buyer, or both? In states where telephone companies are subject to entry and exit regulation, the regulator must approve both the transfer of control and the current incumbent’s decision to discontinue providing service. In such cases, the regulator can approve the transaction without concurrently relieving the seller of its preexisting service obligations, in effect causing the seller to maintain an interest in assuring the successful outcome of the transfer. In the recent Verizon-FairPoint sale, for example, the Vermont PSB specifically held off granting Verizon formal authorization to abandon its service obligations until Verizon had fulfilled various conditions²¹ and after the completion of a “successful cutover.”²²

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

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

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

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

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

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

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

²² *Id.* at *75.

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

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

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

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

²³ Cal. Pub. Util. Code § 854.

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

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

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

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

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

1. Risks related to potential overexpansion

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

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

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

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

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

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

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

²⁸ Frontier-Verizon S-4 at 24.

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

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

Sources:

(1) Annual Reports of GTE Corporation (1999) and Bell Atlantic Corporation (1998). Both available on Verizon website www.verizon.com.

(2) *SBC to acquire Ameritech*, Network World, August, 1998. Available at www.networkworld.com.

'02.

(4) Verizon 3rd Quarter 2006 Earnings Report. Available on Verizon Website www.verizon.com and FCC Trends in Telephone Service, Feb '07

(5) Annual Report, Verizon (2008). Available on Verizon website www.verizon.com.

As the table demonstrates, in the three merger/acquisitions identified as “Buyer remained financially stable,” the ratio of lines acquired to lines provisioned by the purchasing entity is less than one. In the case of both the original acquisition of the GTE exchanges by Bell Atlantic in 2000 (creating Verizon) and the later SBC acquisition of the Ameritech companies, the number of lines served by the post-merger firm was approximately 60% greater than pre-merger. The 2000 sale of Qwest exchanges (a total of 17,000 access lines) to Citizens (which operated less than 2 million lines pre-acquisition) represented an increase of approximately 10%. Conversely, Verizon’s sale of 1.5 million access lines to FairPoint, which increased that company to five times its original size, and the Verizon sale of the 700,000 lines of the former GTE Hawaii (to a private equity group) both resulted in bankruptcy. With the addition of the 4.8 million Verizon access lines across fourteen states that Frontier proposes to purchase, the new expanded Frontier would have three times as many access lines as the pre-acquisition Frontier. While regulators cannot assume that the Verizon-Frontier transfer will take the same path as the Verizon-FairPoint sale, it would make sense for them to intensify their scrutiny of any areas where the buyer’s rapid

expansion could jeopardize its operational or financial stability. To overcome these concerns, the buyer must be prepared to offer concrete plans to accomplish a smooth operational transition and long-term financial stability, as well as contingency plans. The buyer might also strengthen its case by offering sensitivity analyses on all critical assumptions, so that the regulator can evaluate the likelihood that the buyer will accomplish the requisite public interest objectives under unpredictable real-world conditions.

2. Financial

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

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

a. Problems related to overpaying for the acquisition

If the buyer pays too much—i.e., more than the economic value—for the business it is acquiring, it will have trouble generating the revenue to sustain the business. In evaluating the deal, the regulator must thus determine whether the assets and operations subject to the sale are properly priced. The regulator cannot assume a proper price simply from an arm's-length business transaction. U.S. corporations routinely engage in mergers and acquisitions that, in

