BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UM 1484

In the Matter of CENTURYLINK, INC., Application for Approval of Merger between CenturyTel, Inc., and Qwest Communications International, Inc.	OPENING BRIEF OF TRACER

I. INTRODUCTION

Pursuant to the briefing schedule established by the Administrative Law Judge at the conclusion of the evidentiary hearing, the Telecommunications Ratepayers Association for Cost-based and Equitable Rates ("TRACER") hereby files this Opening Brief in the above entitled matter concerning the proposed acquisition of the Qwest Operating Companies ("Qwest")[1] by CenturyTel, Inc. and its affiliates ("CenturyLink").[2]

TRACER is a coalition of large end-users of telecommunications services in the state of Oregon. Its members, which include higher-education institutions operating in the state, obtain a broad variety of communications services, and its individual customer locations (both urban and rural) cover a wide range of sizes. Qwest is the largest local exchange provider for

[1] The Qwest Operating Companies include Qwest Communications International, Inc., Qwest Corporation, Qwest LD Corp., and Qwest Communications Company LLC.

[2] CenturyLink, as referred to herein, includes CenturyTel, Inc., CenturyTel of Oregon, Inc., CenturyTel of Eastern Oregon, Inc., and United Telephone Company of the Northwest (dba Embarq).

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TRACER's members.

It is very important to TRACER members that the services they purchase are provided in an efficient manner, at reasonable cost, and with the highest service quality and performance. TRACER members are concerned that any change in Qwest's corporate governance, systems, personnel, services, and regulatory policies be seamless and that there be no rate increases, service disruptions, or other retail service quality degradation arising from the transaction.

TRACER members are also concerned that CenturyLink's proposed acquisition of Qwest (the "Proposed Merger") not be implemented in such a way as to degrade wholesale services or disadvantage Qwest's dependent competitors. TRACER members are particularly concerned about wholesale issues because in its Pricing Plan approved in UM 1354 Qwest has been granted considerable pricing flexibility for the retail services TRACER members purchase; accordingly, maintaining a strong and robust competitive market in Oregon is the only real protection TRACER members have against unreasonable price increases by Qwest.

Because the merged company will be a critical wholesale provider of services and facilities to competitive retail telecommunications providers, any order approving the Proposed Merger must contain conditions sufficient to ensure that the service quality performance, the practices, and the operations of the merged company support fair and effective competition among carriers in providing services to business, educational, and governmental customers and the general public in Oregon.

II. ARGUMENT

A. In Order To Approve The Proposed Merger The Commission Must Be Able To Find That It Will Not Harm The Public Interest.

In considering whether to approve this transaction pursuant to ORS 759.375 and ORS 759.380, the Commission applies the "in the public interest, no harm" standard.[3] In other

[3] Staff/100, Dougherty/4, lns. 13-15.

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words, the Commission can find this transaction is in the public interest only if the public is no worse off with the merger than without it. In the context of this case, that means that the Commission must impose sufficient conditions to ensure that costs related to the transaction, including the costs of integrating the businesses of the Merged Company, are not borne by the Merged Company's retail or wholesale customers, and that retail and wholesale service quality are not degraded as a result of the transaction. In addition, the transaction must not result in any harm to the competitive marketplace. As the Commission stated in its review of recent the transaction between Frontier Communications and Verizon Northwest, "[t]he continued existence of a robust, competitive marketplace is essential to satisfying the 'no harm' standard for the transaction."[4]

As demonstrated below, the Proposed Merger poses substantial risks of harm to retail customers, particularly Qwest's retail customers whose services are subject to significant pricing flexibility under Qwest's Pricing Plan. The Proposed Merger also poses substantial risks to CLECs and the competitive marketplace. While a settlement between the Joint Applicants and the Commission Staff and CUB and a second one with Integra have been submitted to address many of these risks, neither of the settlements adequately address the risks to either retail or wholesale customers. Accordingly, the Commission must impose additional conditions before it can find that the Joint Applicants have met their burden to demonstrate that this Proposed Merger is in the public interest.

In TRACER's view, the imposition of sufficient wholesale conditions is just as important for the protection of retail customers as is the imposition of meaningful retail conditions. As noted above, that is because maintaining an effective and robust competitive market is the only real protection many business, educational, and governmental customers

[4] *In the Matter of Verizon Communications Inc. and Frontier Communications Corporation Joint Application for an Order Declining to Assert Jurisdiction, or, in the alternative, to Approve the Indirect Transfer of Control of Verizon Northwest Inc*, Order No. 10-067 at 20, docket UM 1431 (entered February 24, 2010).

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have against unreasonable prices and degrading service quality from the incumbent providers.

B. The Proposed Merger Poses Substantial Risks of Harm to Business, Educational, And Governmental Customers In Oregon.

1. There Is A Significant Risk Of Rate Increases To Fund Transition And Integration Costs Until Synergy Benefits Are Achieved.

According to CenturyLink, one of the primary benefits flowing from the proposed transaction is "[i]mproved operating and capital efficiency through reductions in corporate overhead and the elimination of duplicative functions and systems."[5] In fact, CenturyLink asserts that the merger with Qwest will generate annual synergies of $625 million.[6] These synergies are expected to take the form of reduced corporate overheads, network and operational efficiencies, IT support, increased purchasing power, and the combining of the two companies' advertising and marketing programs. But these synergies are difficult to forecast, and they may not develop as expected.

Whatever the synergies, they come at a substantial cost. CenturyLink estimates that there will be one-time operating costs of $650 to $850 million to achieve the planned synergies nationwide. On top of that an additional $150 to $200 million in capital costs will be required.[7] These costs are also estimates, and the company concedes that they could be exceeded. Moreover, these costs will be incurred before the benefits of the synergies are felt, so that they represent a **net new requirement for funds.**[8]

It is not clear where the money for these transition costs will come from. According to CenturyTel witness, John Jones, based on 2009 financials, the merged CenturyTel and Qwest would generate about $1.7 billion in free cash flow, which could be used to retire the integration costs.[9] However, as Mr. Bailey testified, the merged company expects to use the

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[5] CTL/300, Bailey/13, at lns. 6-7.
[6] *Id.*, at p. 14, lns. 1-6; see also, Cross-Examination of John Jones, Tr. Vol. 1 (12-16-10), pp. 100, lns. 18-22.
[7] Cross Examination of John Jones, Tr. Vol. 1 (12-16-10), p. 100, ln. 22 to p. 101, ln. 2.
[8] Cross Examination of John Jones, Tr. Vol. 1 (12-16-10), p. 101, lns. 4-15.
[9] Cross Examination of John Jones, Tr. Vol. 1 (12-16-10), p. 102, lns. 2-19.

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$1.7 billion in remaining cash flow for debt repayment and additional investment.[10] Given the fact that key parts of the rationale for the merger are to expand service offerings (including IPTV and high-speed Internet services), which require substantial investment, and reduce debt, while paying "appropriate compensation" to capital providers,[11] it is unlikely the merged company will look to bond or stock sales. Instead, it is likely CenturyLink will look to its local retail and wholesale operations, including those in Oregon, to meet the urgent requirement to increase revenue.

Moreover, the estimates of synergies and integration costs do not define the entire scope of the threat of possible rate increases to retail or wholesale customers. CenturyLink acknowledges that the costs of completing the merger and integrating Qwest's business, operations, networks, systems, technologies, policies and procedures with those of CenturyLink could turn out to be greater than expect. CenturyLink also acknowledges that the synergies (savings) it expects to achieve from the elimination of duplicative expenses and the realization of economies of schal and costs savings related to the integration of the businesses could be less or delayed longer than expected. may not develop as expected In its July 16, 2010 SEC Form S-4 describes the risks as follows:

> **CenturyLink expects to incur substantial expenses related to the merger.**
>
> CenturyLink expects to incur substantial expenses in connection with completing the merger and integrating the business, operations, networks, systems, technologies, policies and procedures of Qwest with those of CenturyLink. There are a large number of systems that must be integrated, including billing, management information, purchasing accounting and finance, sales, payroll and benefits, fixed asset, lease administration and regulatory compliance. While CenturyLink has assumed that a certain level of transaction and integration expenses would be incurred, there are a number of factors beyond its control that could affect the total amount or the timing of its integration expenses. Many of the expenses that will be incurred, by their nature, are difficult to estimate accurately at the present time. Moreover, CenturyLink expects to commence these integration initiatives before it has completed a similar integration of its business with the business of Embarq, acquired in 2009, which could cause both of these

[10] CTL/300, Bailey 13, lns. 14-17; *Id.*, at p. 14, lns. 13-15.
[11] CTL/300, Bailey 12, ln. 14 to 13, ln. 7.

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integration initiatives to be delayed or rendered more costly or disruptive than would otherwise be the case. Due to these factors, the transaction and integration expenses associated with the Qwest merger could, particularly in the near term, exceed the savings that CenturyLink expects to achieve from the elimination of duplicative expenses and the realization of economies of scale and cost savings related to the integration of the businesses following the completion of the merger. As a result of these expenses, CenturyLink expects to take charges against its earnings before and after the completion of the merger. The charges taken after the merger are expected to be significant, although the aggregated amount and timing of such charges are uncertain at present.

Following the merger, the combined company may be unable to integrate successfully the **businesses of CenturyLink and Qwest and realize the anticipated benefits of the merger.**

The merger involves the combination of two companies which currently operate as independent public companies. The combined company will be required to devote significant management attention and resources to integrating the business practices and operations of CenturyLink and Qwest. Potential difficulties the combined company may encounter in the integration process include the following:

- the inability to successfully combine the businesses of CenturyLink and Qwest in a manner that permits the combined company to achieve the cost savings anticipated to result from the merger, which could result in the anticipated benefits of the merger not being realized in the time frame currently anticipate or at all;
- lost sales and customers as a result of certain customers of either of the two companies deciding not to do business with the combined company;
- the complexities associated with managing the combined businesses out of several different locations and integrating personnel from the two companies, which at the same time attempting to provide consistent, high quality products and services under a unified culture;
- the additional complexities of combining two companies with different histories, regulatory restrictions, markets and customer bases, and initiating this process before CenturyLink has fully completed the integration of its oprations with those of Embarq;
- the failure to retain key employees of either of the two companies;
- potential unknown liabilities and unforeseen increased expenses, delays or regulatory conditions associated with the merger; and
- performance shortfalls at one or both of the two companies as a result of the diversion of management's attention caused by completing the merger and integrating the companies' operations.[12]

Thus, the real risk of rate increases for retail customers could be even greater than if everything goes as CenturyLink expects. If the merged company increases its rates unilaterally

[12] CenturyLink SEC Form S-4, dated July 16, 2010, at 15-17, included in Staff/102, Dougherty/16-17.

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to fund the merger, then its customers would have been better off it the merger had never taken place.

2. The Retail Conditions In The Staff Settlement Are Ambiguous And Are Inadequate To Protect Retail Customers From Rate Increases To Pay For The Costs Of The Merger And Integration Of The Merging Companies' Businesses; They Should Be Clarified.

In direct testimony Staff witness, Michael Dougherty noted the risk of rate increases to retail customers to fund the one-time operating and capital costs required to achieve the planned synergies. He recommended that the Commission adopt conditions to ensure that customers will not be harmed by higher rates that result from the transaction.[13] Sections 8, 9, and 10 of the Staff Stipulation are intended to embody those conditions; however, the language of those sections is ambiguous and could be read in such a way as to eviscerate any protections for retail customers, particularly those for whom Qwest has substantial pricing flexibility under its Pricing Plan approved in Docket UM 1354.

For example, Section 9 of the Staff Stipulation provides in part: "Operating Companies will not seek recovery of one-time transition, branding or transaction costs in Oregon intrastate **regulated rate proceedings.**" (Emphasis added.) It is not clear what is meant by "regulated rate proceedings". In particular, it is not clear whether it includes rate increases under Qwest's Pricing Plan approved in UM 1354? If not, section 9 does not provide any protection to business customers (other than those in Rate Group 3 and customers of the first line at a location) against rate increases to recover one-time transition, branding or transaction costs.

Fortunately, CenturyTel witness John Jones testified that it is CenturyTel's intent that Oregon retail customers not be impacted by changes in rates as a result of the transaction.[14] He also testified that the term "regulated rate proceedings" includes rate increases under the Qwest Pricing Plan approved in Docket UM 1354[15] and that CenturyLink "would not use that process

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[13] Staff/100; Dougherty/29, at lns. 7-8.
[14] Cross Examination of John Jones, Tr. Vol. 1 (12-16-10), p. 103, lns. 21-24.
[15] Cross Examination of John Jones, Tr. Vol. 1 (12-16-10), p. 104, lns. 21-24.

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to increase rates."[16]

To remove any doubt about the proper interpretation, the Commission should amend Condition 9 of the Staff Stipulation by adding: "For purposes of this condition, 'regulated rate proceedings' shall be construed to include rate increases under the Qwest Pricing Plan approved in Docket UM 1354."

Section 10 of the Staff Stipulation is also ambiguous and needs clarification. Section 10 provides:

> The **Merged Company** will not recover, or seek to recover through wholesale or retail service rates or other fees paid by wholesale or retail customers any increases in **overall management costs that result from the transaction**, including those incurred by the **operating companies**. For purposes of this condition, **"transaction-related costs"** shall be construed to include all **Merged Company** costs related to or resulting from the transaction and any related transition, conversion, or migration costs and, for example, shall not be limited in time to costs incurred only through the Closing Date.

"Merged Company" is capitalized and appears to be a defined term, but there is no definition of that term in the Stipulation. It is not clear whether "Merged Company" includes the operating companies. Again, Mr. Jones testified that CenturyTel's understanding is that the term includes the Oregon properties and that it is the company's intent that the operating companies, which are the ones that actually provide services to retail customers, would not seek to recover any of the transaction or integrations costs in rates.[17]

It is also unclear what is included in "overall management costs that result from the transaction." The second sentence in Condition 10 contains a reference to "transaction-related costs" as if that term were used above; however, it is not used elsewhere. Is that intended to be the same as "overall management costs that result from the transaction"? Mr. Jones testified that it is.[18] He also testified that it includes all of the integration costs referred to in the

[16] *Id.* at lns 19-20.
[17] Cross Examination of John Jones, Tr. Vol. 1 (12-16-10), p. 105, ln. 17 to p. 106, ln. 3.
[18] Cross Examination of John Jones, Tr. Vol. 1 (12-16-10), p. 108, ln. 23 to p. 109, ln. 19.

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CenturyTel SEC Form S-4 at pages 16-17.[19]

To reflect the intent of the parties and avoid unnecessary ambiguity the Commission should amend Condition 10 of the Staff Stipulation to read as follows:

> The Merged Company **(including the operating companies)** will not recover, or seek to recover through wholesale or retail service rates or other fees paid by wholesale or retail customers any increases in overall management costs that result from the transaction, including those incurred by the operating companies. For purposes of this condition, **"overall management costs"** shall be construed to include all Merged Company costs related to or resulting from the transaction and any related transition, conversion, or migration costs and, for example, shall not be limited in time to costs incurred only through the Closing Date.

3. Even If The Retail Conditions Are Clarified, Many End-Users Are Still At Risk Of Rate Increases As A Result Of The Transaction .

Even if the retail conditions of the Staff Stipulation are clarified as proposed above, many end-users will still be at risk of rate increases as a result of the proposed transaction. That is because, regardless how they are written, the retail conditions will still be very difficult to enforce in the context of the Qwest Pricing Plan. That Plan simply imposes rate caps and allows use of price lists. It will be problematic for the Staff or any customer to determine and demonstrate that the particular price increase was undertaken to pay for merger transaction or integration costs or to finance additional investment, reduce debt, or compensate shareholders. While clear retail conditions are important, the bottom line is that the extent to which the merged company can get additional revenue from its customers is dependent on the extent to which competition limits its ability to increase rate unilaterally. TRACER members believe that the only real protection they have is maintaining a healthy competitive market.

C. The Merging Companies Have Not Committed to Sufficient Conditions To Prevent A Degradation Of Wholesale Service Quality As A Result Of The Merger.

1. The Proposed Merger Also Poses A Significant Risk Of Harm To Wholesale Customers And To Local Competition In Oregon

[19] Cross Examination of John Jones, Tr. Vol. 1 (12-16-10), p. 106, ln. 16 to p. 108, ln. 22.

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As pointed out by Dr. Ankum, most Oregon CLECs are dependent on Qwest and CenturyLink for interconnection and other essential wholesale services.[20] Moreover, because they compete with the CLECs operating in their territories, the merging companies have a strong incentive to undermine their wholesale CLEC customers by increasing wholesale rates, diminishing service quality, reducing resources devoted to wholesale customers, or eliminating wholesale offerings on which CLECs depend.[21] It is beyond dispute that the proposed merger creates additional incentives on the part of the merged company and its operating subsidiaries to discriminate against and disadvantage dependent competitors. Since a strong, viable competitive market is TRACER members' only real protection against unwarranted price increases/exercise of incumbents' market power, it is essential that there be strong and meaningful wholesale conditions imposed on the merger.

TRACER is particularly concerned about the risks to service quality resulting from this transaction. As discussed at length in the direct testimony of Dr Ankum, a number of recent large wireline acquisitions have resulted in severe service quality degradation: (1) Hawaiian Telecom's acaquisition of Verizon Hawaii; (2) FairPoint's acquisition of Verizon operations in northern New England; and (3) Frontier's acquisition of 4.8 million Verizon lines in 14 states.[22] TRACER is concerned that a similar deterioration of service might develop following he transfer of Qwest to CenturyLink, for two primary reasons.

The first is discussed above: the pressure to finance the implementation of the merger. While price increases for retail customers may be one source of funds for the merger implementation, another source could easily be cost cutting in the form of reduced resources, including capital investment and manpower devoted to plant maintenance and customer service, particularly in the wholesale arena. Naturally this would lead to a deterioration of

[20] Joint CLECs/1, Ankum/13, lns. 12-14.
[21] *Id.* at lns. 14-17.
[22] Joint CLECs/1, Ankum/25-36.

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service performance.

The second reason for concern is the incompatibility of the Qwest and CenturyLink operating support systems. To achieve the forecasted synergies, CenturyLink will have to integrate its protocols and IT systems with those of Qwest. This integration comes on top of the already complex integration of the Embarq systems wit those of CenuryTel. As noted in the quoted section of the CenturyTel S-4 filing, CenturyLink has conceded that this integration could present several difficulties. Past experience has demonstrated that these difficulties can result in degraded service performance and excessive costs.

2. The Staff And Integra Settlements Are Inadequate To Protect Against Harm To Wholesale Customers And Local Competition; Additional Conditions Are Required.

TRACER concurs with the arguments of the Joint CLECs that the Staff and Integra Settlements fail to adequately address the potential harm of the proposed transaction to wholesale customers and to local competition. TRACER also generally agrees with the additional conditions recommended by the Joint CLECs to address this potential harm to the public interest. Accordingly, TRACER will not repeat the Joint CLECs' arguments.

In addition, TRACER is particularly concerned that the Staff/Integra Settlements do not go far enough in protecting against a degradation of wholesale service quality. That is because a degradation of wholesale service quality can not only affect end-users that take service from competitive providers, but it can adversely affect local competition as a whole. From an end-user's perspective it doesn't make any real difference who is responsible for a service quality problem. The end user doesn't really care. What is important is that there is a problem and that it be fixed as soon as possible. If the poor service quality can be avoided by taking service from the incumbent, then the competitive provider isn't really a viable option. If competitive providers cannot be seen as viable options because wholesale service quality from the incumbent declines, all retail customers suffer. Without strong and viable competitors, there

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will be no restraint on the incumbent from raising prices or letting its own service quality decline.

TRACER believes it is critical that there be a performance assurance plan that actually tracks changes in wholesale service quality in the Qwest territory and compares post-merger wholesasle service quality with wholesale service quality before the merger. Further, any performance assurance plan should include a self-executing set of penalties that act as a disincentive for the merged company to try to achieve synergies by allowing wholesale service quality to decline. TRACER believes the Joint CLECs' proposal for an alternative wholesale performance assurance plan, the "APAP" meets these criteria and should be adopted as a condition of approving the merger.

While the Staff Settlement requires the Merged Company to meet or exceed the average wholesale performance provided by Qwest to the CLECs for a certain time following the merger and to conduct a root cause analysis if wholesale service quality deteriorates, these are not sufficient incentives for the merged company to maintain wholesale service quality levels post-merger. First, the comparison wouldn't even be between pre-merger and post-merger service quality.

Second, the root cause provision (Staff Settlement Condition 34(b)) does not provide any self-effectuating incentives so that, if/when post-merger wholesale service quality deterioration occurs, the merged company is properly motivated to resolve these problems immediately and without the need for additional litigation and disputes.[23] The root cause provision that requires the merged company to determine why service quality problems are occurring and to develop a plan to rectify them is of little benefit to CLECs and their end users who will be experiencing service-affecting problems and disruptions.[24]

Moreover, it is inappropriate to shift the burden of proving harm to the CLECs as

[23] *Id.* at p. 44, lns. 1-22.
[24] *Id.*

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CenturyLink and Qwest argue.[25] It is the applicants' burden to demonstrate that the merger will not harm the public interest.

It is not in the public interest to approve the merger based on a commitment from the merged company to simply investigate merger-related wholesale service quality problems as they occur and propose a plan to fix them; instead, the proposed merger should not be approved unless there are sufficient assurances that wholesale service quality deterioration does not occur in the first place. The APAP is an essential self-effectuating mechanism to ensure that during the synergy period the merged company's performance in the legacy Qwest ILEC territory does not deteriorate as compared to pre-merger performance. If the merged company acts as CenturyLink and Qwest say it will, and there is no degradation in service, then the merged company will not be subjected to any payments or penalties. Only if the merged company fails to live up to representations that CenturyLink and Quest have made to the Commission will the APAP provisions be triggered.

Based on the record in this proceeding, the Commission should adopt the Joint CLECs' proposed APAP condition and require that it remain in place for the duration of the synergy period, whether that be three years, five years, or longer. As CenturyLink has acknowledged, there is a risk that the projected synergies will not be as great as estimated, or be delayed longer than expected, or perhaps not materialize at all.[26] The key is that the APAP remain in place as long as the incentive to cut costs at the expense of wholesale service quality exists.

TRACER acknowledges that Qwest and CenturyTel have raised a number of questions about how the Joint CLECs' proposed APAP would work. While TRACER believes those questions have largely been answered, it recommends that the more appropriate course for the Commission would be to require that an appropriate self-executing wholesale performance assurance plan be implemented as a condition for approving the merger. The Commission then

[25] Rebuttal Testimony of Michael G. Williams, Exhibit MGM-1RT, at p. 20, ln. 22 to p. 21, ln. 3.
[26] CenturyLink LEC Form S-4, dated July 16, 2010, at 15-17, included in Staff/102, Dougherty/16-17.

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should open an expedited docket to more fully evaluate the issues that have been raised about the Joint CLECs' APAP and make corrections, if needed. Alternative plans could also be considered. The bottomline is that the goal of that docket should be to adopt a specific wholesale performance assurance plan that would provide proper incentives for the merged company to prevent service quality degradation.

III. CONCLUSION AND RECOMMENDATION

Based on the foregoing, TRACER urges the Commission to adopt the proposed clarifications to the retail conditions in the Staff Settlement discussed herein in addition to the conditions set forth in the testimonies and brief of the Joint CLECs.

RESPECTFULLY SUBMITTED this 25th day of January, 2011.

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