STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

FairPoint Communication Inc., C-R Telephone Company, The El Paso Telephone Company, Odin Telephone Exchange, Inc. and Yates City Telephone Company	)	
	)	Docket No. 04-0299 (Reopening)
Joint Application for approval of the Recapitalization of FairPoint Communications, Inc. pursuant to Sections 7-203 and 7-204 and for other relief.	)	

VERIFIED COMMENTS OF STAFF OF THE ILLINOIS COMMERCE COMMISSION

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Attachments: Verifications of
Mark Hanson, Telecommunications Division
Alan Pregozen, Financial Analysis Division
Theresa Ebrey, Financial Analysis Division
Samuel S. McClerren, Telecommunications Division

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VERIFIED COMMENTS OF STAFF OF THE ILLINOIS COMMERCE COMMISSION

FairPoint Communications, Inc. (FairPoint"), C-R Telephone Company ("C-R"), The El Paso Telephone Company ("El Paso"), Odin Telephone Exchange, Inc. ("Odin") and Yates City Telephone Company ("Yates") (collectively "Applicants"), jointly filed an *Verified Motion to Reopen For Purposes of Entering Amended Order on Reopening* on December 21, 2004 ("Motion"), with this Commission. Attached to the *Motion* was an *Amended Joint Application on Reopening* ("Reopening Application"). Applicants had sought and obtained approval from the Commission a recapitalization and reorganization in March 2004. The Commission approved their petition subject to seven conditions, as set forth in an order issued on May 26, 2004 ("Order"). Applicants seek to amend the Order, and the *Reopening Application* requests that the Commission approve its reorganization and recapitalization pursuant to Sections 7-203 and 7-204 of the Public Utilities Act ("PUA").

Staff has reviewed the *Reopening Application*, the *Motion* and its attachments and other relevant information and sets forth its conclusions herein. In support of its position, Staff states the following herein:

I. LEGAL AUTHORITY

Joint Applicants are requesting approval of the reorganization of ICTC pursuant to Section 7-204 of the Illinois Public Utilities Act. Section 7-204 (220 ILCS 5/7-204) applies to public utilities and noncompetitive telecommunications rates and services of telecommunications carriers. *See* §13-101.

Section 7-204 requires Commission approval of certain defined forms of reorganization of a public utility. A reorganization is "any transaction which . . . results in a change in the ownership of a majority of the voting capital stock of an Illinois public utility; or the ownership or control of any entity which owns or controls a majority of the voting capital stock of a public utility . . . ." §7-204(a). In reviewing a reorganization, the Commission must make the following findings:

> (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.
>
> §7-204(b).

In addition, 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.
>
> §7-204(c)

In approving a reorganization pursuant to Section 7-204 the Commission "may impose such terms, conditions or requirements . . . that are necessary to protect the interests of the public utility and its customers." §7-204(f).

II. STAFF POSITION

Staff has reviewed the *Motion* and its attachments, the *Reopening Application* and other relevant information to determine the Applicant's compliance with the findings set forth in 7-204(b) and 7-204(c). Staff's conclusions are set forth below and are premised upon the Applicants being subject to the seven conditions set forth in the *Order*. The seven conditions in the *Order* are still necessary to ensure that the reorganization does not adversely affect C-R's, Odin's, El Paso's and Yates City's

("Operating Companies") ability to perform their duties under the PUA, and to protect the interests of the Operating Companies and their customers. In addition, Staff has added one condition (*infra* §II(A)) and three reporting requirements (*infra* §II(I)) that Operating Companies are to comply with in the time periods set forth below.

A. Carrier's Ability to Provide Adequate, Reliable, Efficient, Safe and Least-cost Service

Staff finds that the proposed reorganization will not diminish the utility's ability to provide adequate, reliable, efficient, safe and least-cost public utility service. This is based on Staff's finding that there are no service quality problems in the Petitioners' territories, and believes the agreement reached in Docket 04-0299 will provide adequate safeguards to prevent back sliding.

Further, Staff is relying on Applicants' representation that any restriction on capital expenditures in the proposed credit facility agreement will not prevent Applicants from meeting its obligations under the PUA or the service quality standards set forth in Condition 6. Nevertheless, since the credit facility agreement has not been finalized, Staff and Applicants have agreed to add the following Condition:

> 8. FairPoint's credit facility agreement shall provide that the ceiling on aggregate capital expenditures in any fiscal year for FairPoint and its subsidiaries shall be at least 30% of FairPoint's Earnings before Interest, Taxes, Depreciation and Amortization (EBITDA) for such fiscal year.

This condition is designed to reduce the probability that any limits placed on FairPoint's capital expenditures by the senior credit facility do not curtail needed capital improvements to the systems of CR, Odin, El Paso and Yates City.

There is one outstanding matter and it is reflected in Condition 6 of the May 26, 2004 Final Order. During the initial proceeding it was noted that the four Operating Companies had filed for a waiver of Parts 730.510(a) and 730.510(b) (*see* Docket Nos. 04-0278 (C-R), 04-0279 (El Paso), 04-0280 (Odin), 04-0281 (Yates City)). A final order has not yet been issued in those dockets, therefore their petitions for waiver have not yet been granted. On March 31, 2004 the Commission issued a notice of Commission Action in each docket temporarily suspending the requirements of Part 730.510(a) and 730.510(b) as it applies to each Operating Company. The temporary suspension is effective until the Commission issues an order granting or denying their petitions, it is based on a preliminary finding, and it carries no weight in determining the propriety of the permanent waiver requested by the Operating Companies. As a consequence of these dockets, Staff proposed the following as part of Condition 6:

> If any of the Operating Company's are granted a permanent waiver from having to comply with a key service quality measure in Dockets 04-0278 through 04-0281, then that service quality measure shall not be included in the list. Until the Commission issues an order in Docket Nos. 04-0278, 04-0279, 04-0280, and 04-0281, key service quality measures Toll & Assistance Answer Time, Information Answer Time, Business Office Answer Time and Repair Office Answer Time shall be included in the condition, but not used to determine compliance with this condition. If a permanent waiver is denied, then those service quality measures shall be used to determine compliance.

Based on workshops and testimony filed in Docket Nos. 04-0278, 04-0279, 04-0280, and 04-0281, Staff is optimistic that a permanent waiver from having to comply with the key service quality standards themselves will not occur. FairPoint appears to be of the same opinion, since it stated in its motion:

> The Applicants in those dockets, including the FairPoint Operating Companies and Staff have agreed to modifications with regard to the method and means by which the respective companies will calculate and report compliance with Part 730 – Answer Time Standards so as to no longer necessitate a waiver of the actual standards set forth in Part 730. However, this development does not require any change in Condition #6 as set forth in the Commission's May 26, 2004 Order nor the incorporation of that condition, as written, in an Order on Reopening.
>
> Verified Motion to Reopen For Purposes of Entering Amended Order on Reopening, at 4 n.1 (filed Dec. 21, 2004)

Therefore, the status of the waivers have not changed and the above-quoted portion of Condition 6 should remain in effect. In addition, Staff agrees with FairPoint's statement that Condition #6 does not need to be changed.

B. Subsidization of Non-utility Activities by the Utility or its Customers;

In the initial proceeding, Staff found that the proposed reorganization would not result in the unjustified subsidization of non-utility activities by the utility or its customers in compliance with Section 7-204(b)(2), provided certain conditions were agreed to. The *Order* adopted such conditions. The Applicants stated in paragraph 8 of *Motion* that they will remain subject to the same conditions approved in the *Order.* Since the Company continues to agree with the conditions stated in the *Order*, and no information has been presented to Staff in this reopening that changes that conclusion, the conclusion Staff reached in the initial proceeding does not change.

C. Fair and Reasonable Allocation of Costs Between Utility and Non-utility Activities

In the initial proceeding, Staff found that costs and facilities were fairly and reasonably allocated between utility and non-utility activities such that the Commission may identify those costs and facilities which are properly included by the utility for

ratemaking purposes in compliance with Section 7-204(b)(3), provided certain conditions were agreed to. The *Order* adopted such conditions. The Applicants stated in paragraph 8 of *Motion* that they will remain subject to the same conditions approved in the *Order.* In this reopening there has been no information presented to Staff that changes the conclusion it reached in the initial proceeding.

D. Carrier's Ability to Raise Necessary Capital or Maintain a Reasonable Capital Structure

Given the proposed conditions described in the Company's filing, Staff has concluded that the proposed reorganization and recapitalization will not significantly impair the utility's ability to raise necessary capital on reasonable terms or to maintain a reasonable capital structure. Staff's position is based on the following facts:

(1) C-R, Odin, El Paso and Yates City have no debt outstanding.
(2) C-R, Odin, El Paso and Yates City currently generate more cash than they require for their own capital expenditure budgets.
(3) The credit facility agreement that is part of Applicant's recapitalization will restrict the type and amount of debt C-R, Odin, El Paso and Yates City will be able to incur.
(4) FairPoint's current issuer credit ratings are B2 from Moody's Investors Service, which is five ratings notches below the minimum investment grade rating of Baa3, and B+ from Standard & Poor's, which is four ratings notches below the minimum investment grade rating of BBB-.
(5) The proposed reorganization and recapitalization will reduce the proportion of debt in FairPoint's capital structure from existing levels.

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. Staff concludes that under the proposed reorganization the Operating Companies will have little, if any <u>need</u> to access capital given that (a) the Operating Companies currently generate sufficient cash for to fund their capital

expenditure budgets; (b) Condition 6, which would prevent the Operating Companies from transferring that cash if they fail to meet the service quality standards described in that Condition; (c) the ability, albeit constrained, of the Operating Companies to access certain types and amounts of debt under the proposed credit facility agreement; and (d) Condition 7's requirement that FairPoint reserve a portion of its credit facility for the Operating Companies.

Further, Staff concludes that the reduction in the proportion of debt in FairPoint's capital structure would enhance FairPoint's ability to raise further capital on reasonable terms should the need arise. Such a reduction of debt would be from both its current level and that level which would have resulted from the reorganization and recapitalization approved in the *Order.* Nevertheless, Staff does not expect FairPoint to achieve the degree of financial strength necessary for FairPoint to raise capital on reasonable terms under most capital market conditions until FairPoint 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. Staff interprets "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. Staff concludes that none of the Applicants currently maintain a reasonable capital structure. The Operating Companies have no debt and the loan agreements that are part of the proposed recapitalization and reorganization transactions will likely limit their ability to issue debt that would balance the operating companies' capital structures under the proposed reorganization. (Since Staff has not

seen the final loan agreements, Staff is relying on the representations of Joint Applicants concerning the terms and conditions that likely will be part of those loan agreements. In its response to Staff data request SDR 1.02, the Joint Applicants stated that the term loan agreement is not yet available.) When the Commission sets rates, it typically uses the parent company's capital structure for subsidiaries that rely on that parent to supply external capital. The proposed reorganization and recapitalization would reduce the proportion of debt in FairPoint's capital structure; although, Staff does not expect that reduction in debt will be sufficient for FairPoint to attain investment grade credit ratings from either Standard & Poor's or Moody's Investment Service. From this standpoint, the proposed reorganization can be deemed to enhance the ability of FairPoint, and through FairPoint, the ability of the Operating Companies, to achieve a reasonable capital structure.

In summary, Staff concludes that together with the proposed conditions, 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.

E. Carrier Subject to Illinois' Laws

In the initial proceeding Staff found that the utility would remain subject to all applicable laws, regulations, rules, decisions and policies governing the regulation of Illinois public utilities. There has been no information presented to Staff in this reopening that changes that conclusion.

F. Impact of Reorganization on Competition as Regulated by the State

In the initial proceeding, Staff found that the proposed reorganization was not likely to have a significant adverse effect on competition in those markets over which

the Commission has jurisdiction. There has been no information presented to Staff in this reopening that changes that conclusion.

G. Impact of Reorganization on Rates and Retail customers

In the initial proceeding, Staff found that the proposed reorganization was not likely to result in any adverse rate impacts on retail customers if it complied with a condition. To ensure that FairPoint would continue to comply with finding 7-204(b)(7) on a going forward basis, Staff suggested that retail rates be frozen for one year after the reorganization. The *Order* adopted such a condition. The Applicants stated in paragraph 8 of *Motion* that they will remain subject to the same conditions approved in the *Order.* In this reopening there has been no information presented to Staff that changes the conclusion it reached in the initial proceeding.

H. Allocation of Savings Resulting From the Proposed Reorganization and Recovery of Costs Related to Reorganization

Staff found that were no operational savings from the proposed reorganization since it was financial in nature. Staff believes the same conclusion is warranted during this reopening.

I. Reporting Requirements Related to Recapitalization and Reorganization

FairPoint has informed Staff that the credit facility agreement is not finalized, and that the percentage ownership and voting rights that the current owners of FairPoint will have in the reorganized company will not be known until after the common stock issuance. Staff therefore proposes that the Operating companies file reports apprising Staff of their status after the agreement is finalized, and the initial public offering ("IPO") has concluded. In addition, the Applicants cannot determine at this time the final

sources and uses of the proceeds from both the common stock issuance and the borrowings under the senior credit facility. Therefore, Staff also proposes that the Operating companies file reports apprising Staff of their final status.

Staff recommends the following additional reporting requirements because they will not be finalized until after the order will be issued:

1. C-R, Odin, El Paso and Yates City shall jointly file a report with the Chief Clerk of the Commission that discloses the percentage ownership and voting rights in FairPoint after the IPO. The report should be filed within 45 days of that issuance. That report shall disclose ownership and voting rights of the following stockholder groups: Thomas H. Lee Equity Fund IV, L.P. and affiliates; Kelso Investment Associates V, L.P. and Kelso Equity Partners V, L.P.; founders shareholders of FairPoint; senior management; other shareholders of FairPoint prior to the IPO; and public shareholders.

2. C-R, Odin, El Paso and Yates City shall jointly file with the Chief Clerk of the Commission a copy of the final credit facility agreement, as amended and restated following the reorganization, within 10 days of that agreement's execution, which final credit facility agreement shall contain substantially the same covenants stated in response to Staff data request SDR 1.02; and

3. C-R, Odin, El Paso and Yates City shall jointly file with the Chief Clerk of the Commission a statement of the sources and uses of the proceeds from both the common stock issuance and the borrowings under the amended and restated credit agreement within 10 days of the execution of those capital transactions.

III. CONCLUSION

Staff's review of the Applicants' reorganization and recapitalization concludes that they meet the requirements set forth in Section 7-204(b) and 7-204(c) of the PUA, provided that the Applicants comply with the seven conditions outlined in the *Order*, and the additional condition set forth herein. In addition, Staff recommends that C-R, Odin, El Paso and Yates City be directed to comply with the three reporting requirements, as set forth herein. The eight conditions and three reporting requirements are necessary to (i) protect the interests of the Operating Companies and their customers; and (ii) ensure that the reorganization does not adversely affect the ability of the Operating Companies to perform their duties under the PUA.

Respectfully submitted

Illinois Commerce Commission Staff Witnesses

By:_____
One of its attorneys

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Counsel for Staff Witnesses of the
Illinois Commerce Commission

Date: January 12, 2005

VERIFICATION

I, Mark Hanson, being duly sworn on oath state that I am a(n) Rate analyst in the Rates Department of the Telecommunications Division of the Illinois Commerce Commission, that I have read the foregoing Comments, filed on behalf of the Staff Witnesses in connection with Docket 04-0299, and know the contents thereof, and that the statements of fact therein are true, correct and complete to the best of my knowledge, information, and belief.

Mark Hanson
[Name of Staff Witness]

Subscribed and sworn to
before me this 12th day of January,
2005.

Lisa Bowman
My commission expires: 2007

OFFICIAL SEAL
LISA BOWMAN
NOTARY PUBLIC, STATE OF ILLINOIS
MY COMMISSION EXPIRES 12-9-2007

VERIFICATION

I, Alan Pregozen, being duly sworn on oath state that I am Manager ~~of~~ of the Finance Department of the Financial Analysis Division of the Illinois Commerce Commission, that I have read the foregoing Comments, filed on behalf of the Staff Witnesses in connection with Docket 04-0299, and know the contents thereof, and that the statements of fact therein are true, correct and complete to the best of my knowledge, information, and belief.

1-11-2005

[Name of Staff Witness]

Subscribed and sworn to
before me this 11th day of January,
2005.

My commission expires:

OFFICIAL SEAL
ELIZABETH A. ROLANDO
NOTARY PUBLIC, STATE OF ILLINOIS
MY COMMISSION EXPIRES 11-6-2007

VERIFICATION

I, Theresa Ebrey, being duly sworn on oath state that I am an accountant in the Accounting Department of the Financial Analysis Division of the Illinois Commerce Commission, that I have read the foregoing Comments, filed on behalf of the Staff Witnesses in connection with Docket 04-0299, and know the contents thereof, and that the statements of fact therein are true, correct and complete to the best of my knowledge, information, and belief.

Theresa Ebrey
[Name of Staff Witness]

Subscribed and sworn to
before me this 11 day of January,
2005.

Lisa Bowman
My commission expires: 2007

OFFICIAL SEAL
LISA BOWMAN
NOTARY PUBLIC, STATE OF ILLINOIS
MY COMMISSION EXPIRES 12-9-2007

VERIFICATION

I, Samuel S. McClerren, being duly sworn on oath state that I am an engineering analyst in the Engineering Department of the Telecommunications Division of the Illinois Commerce Commission, that I have read the foregoing Comments, filed on behalf of the Staff Witnesses in connection with Docket 04-0299, and know the contents thereof, and that the statements of fact therein are true, correct and complete to the best of my knowledge, information, and belief.

Samuel S. McClerren

Subscribed and sworn to
before me this 11th day of January,
2005.

Elizabeth A. Rolando

My commission expires:

OFFICIAL SEAL
ELIZABETH A. ROLANDO
NOTARY PUBLIC, STATE OF ILLINOIS
MY COMMISSION EXPIRES 11-6-2007