

DIRECT TESTIMONY

OF

MIKE OSTRANDER

FINANCIAL ANALYSIS DIVISION

ILLINOIS COMMERCE COMMISSION

FRONTIER COMMUNICATIONS CORPORATION,
VERIZON COMMUNICATIONS, INC., VERIZON NORTH INC.
VERIZON SOUTH INC., NEW COMMUNICATIONS OF THE CAROLINAS, INC.
JOINT APPLICATION FOR APPROVAL OF REORGANIZATION
PURSUANT TO SECTION 7-204 OF
THE PUBLIC UTILITIES ACT

DOCKET NO. 09-0268

OCTOBER 20, 2009

1 **Witness Identification**

2 **Q. Please state your name and business address.**

3 A. My name is Mike Ostrander. My business address is 527 East Capitol Avenue,
4 Springfield, Illinois 62701.

5
6 **Q. By whom are you employed and in what capacity?**

7 A. I am currently employed as an Accountant in the Accounting Department of the
8 Financial Analysis Division of the Illinois Commerce Commission (“ICC” or
9 “Commission”).

10

11 **Q. Please describe your professional background and affiliations.**

12 A. I received a Bachelor of Business Administration in Accounting from the
13 University of Notre Dame. I am a Certified Public Accountant and a Certified
14 Internal Auditor. I joined the Commission staff (“Staff”) in March 2006. Prior to
15 joining the Commission, I was employed for three years as a staff accountant in
16 public accounting, seventeen years in private industry with positions ranging from
17 accounting manager to corporate officer encompassing all areas of accounting
18 and internal auditing, and three years as controller of a law firm and software
19 company.

20

21 **Q. Have you previously testified before any regulatory bodies?**

22 A. Yes. I have testified on several occasions before the Commission.

23

24 **Purpose of Testimony**

25 **Q. Please describe the proposed transaction.**

26 A. Frontier Communications Corporation (“Frontier”), Verizon Communications, Inc.
27 (“Verizon”), Verizon North Inc. (“Verizon North”), Verizon South Inc. (“Verizon
28 South”) and New Communications of the Carolinas, Inc. (“NewLEC”) (collectively, the “Joint Applicants”) seek approval of a reorganization pursuant to
29 Section 7-204 of the Illinois Public Utilities Act (“Act”). Frontier is a publicly
30 traded company that owns several incumbent local exchange carriers in Illinois.
31 Frontier has entered into an agreement with Verizon to acquire the Illinois local
32 exchange operations of Verizon North and Verizon South with NewLEC covering
33 the service areas served by Verizon South.
34

35

36 **Q. What is the purpose of your testimony in this proceeding?**

37 A. My testimony addresses the compliance of the proposed reorganization of
38 Frontier with respect to Section 7-204(b)(2) and 7-204(b)(3) of the Act. I also
39 provide a recommendation to the Commission regarding its ruling on Section 7-
40 204(c) of the Act.
41

42 **Compliance with Section 7-204(b)(2)**

43 **Q. Describe the requirements of Section 7-204(b)(2).**

44 A. Section 7-204(b)(2) requires that, before approving a proposed reorganization,
45 the Commission find that the proposed reorganization will not result in the
46 unjustified subsidization of non-utility activities by the utility or its customers.

47

48 **Q. How does the proposed reorganization impact the opportunity for Frontier**
49 **to unjustly subsidize non-utility activities by utility operations?**

50 A. The proposed reorganization of Frontier does not impact the opportunity for the
51 subsidization of non-utility activities of Frontier by utility operations. There is no
52 change that will occur that affects the opportunity for Frontier to subsidize non-
53 utility activities by the utility operations. In direct testimony, Joint Applicants'
54 witness Daniel McCarthy testified that the proposed reorganization will not result
55 in the unjustified subsidization of non-utility activities by Frontier or its customers
56 in its current exchanges or in any of the Verizon exchanges (Joint Applicants'
57 Exhibit 1.0, p. 31).

58

59 **Q. By what means can the Commission be assured that Frontier will not**
60 **unjustly subsidize the non-utility activities by its utility operations?**

61 A. Frontier is subject to the cost allocation requirements of 83 Ill. Adm. Code 711, its
62 cost allocation manual, and FCC cost allocation rules. The proposed transaction
63 will not change the existing cost allocation procedures or accounting methods, as
64 testified to by Mr. McCarthy (Joint Applicants' Exhibit 1.0, page 32).

65 In addition, I recommend that Frontier be subject to the following conditions as
66 further evidence of compliance with Section 7-204(b)(2):

67 1. Commission Staff will be granted access to all books, accounts, records
68 and personnel of Frontier and all of their utility and non-utility affiliated
69 sister and subsidiary companies, as well as independent auditor's working
70 papers, to the extent permitted by the rules and policies of the
71 independent auditor;

- 72 2. Frontier will continue to comply with 83 Ill. Admin. Code 711, Cost
73 Allocation Rules for Large Local Exchange Carriers; and
- 74 3. Frontier will conduct an annual internal audit to test compliance with
75 Section 7-204(b)(2) and 7-204(b)(3). The internal audit report will be
76 submitted to the Manager of Accounting of the Commission by March 31st
77 of each year and associated working papers will be available to
78 Commission Staff for review.

79 The purpose of the internal audit will be to document the procedures
80 performed and conclusions to determine that cost allocations between
81 regulated and non-regulated activities are in compliance with Frontier's
82 cost allocation manual filed with the Commission and that the cost
83 allocation manual is correct and complete.
84

85 **Q. Please explain your rationale for the frequency of the submission of an**
86 **internal audit report and the objective of such internal audit.**

87 A. The Commission currently requires that internal audits be performed on a routine
88 annual basis to insure that there is no cross subsidization of non-regulated
89 operations by the regulated operations of Illinois public utilities.

90 I propose that the Commission Order should include this condition as written
91 above. The description should indicate the purpose of the internal audit so that
92 there is no ambiguity as to what the internal audit should achieve. The internal
93 audit should document the procedures performed and conclusions to determine
94 that cost allocations between regulated and non-regulated activities are in
95 compliance with Frontier's cost allocation manual that is filed with the
96 Commission and that the cost allocation manual is correct and complete.

97

98 **Q. What is your recommendation regarding the finding the Commission must**
99 **make regarding compliance with Section 7-204(b)(2)?**

100 A. I recommend that Frontier be subject to the above conditions in order for the
101 Commission to find that the proposed reorganization will not result in the
102 unjustified subsidization of non-utility activities by the utility or its customers as
103 required by Section 7-204(b)(2).
104

105 **Compliance with Section 7-204(b)(3)**

106 **Q. Describe the requirements of Section 7-204(b)(3).**

107 A. Section 7-204(b)(3) requires that, before approving a proposed reorganization,
108 the Commission find that costs and facilities are fairly and reasonably allocated
109 between utility and non-utility activities in such a manner that the Commission
110 may identify those costs and facilities which are properly included by the utility for
111 ratemaking purposes.
112

113 **Q. How does the proposed reorganization impact the ability of Frontier to**
114 **fairly and reasonably allocate costs and facilities between utility and non-**
115 **utility activities in such a manner that the Commission may identify those**
116 **costs and facilities which are properly included by the utility for ratemaking**
117 **purposes?**

118 A. First, I note that the realities of the modern telecommunications industry, such as
119 the fact that the same facilities are often used to provide non-competitive,
120 competitive, and unregulated services affects the feasibility of identifying the
121 costs and facilities which are properly included by the utility for ratemaking
122 purposes. However, the proposed reorganization does not impact the ability of

123 Frontier to fairly and reasonably allocate costs and facilities between utility and
124 non-utility activities in such a manner that the Commission may identify those
125 costs and facilities which are properly included by the utility for ratemaking
126 purposes. There is no change that will occur that affects the method used by
127 Frontier to reasonably allocate costs between utility and non-utility activities. In
128 direct testimony, Mr. McCarthy testified that the proposed reorganization will not
129 impact the ability of Frontier to fairly allocate its costs and facilities between utility
130 and non-utility activities (Joint Applicants' Exhibit 1.0, p. 32).

131

132 **Q. By what means can the Commission be assured that Frontier will**
133 **reasonably allocate its costs and facilities between utility and non-utility**
134 **activities?**

135 A. Frontier is subject to the cost allocation requirements of 83 Ill. Admin. Code 711,
136 its cost allocation manual, and FCC cost allocation rules. The proposed
137 transaction will not change the existing cost allocation procedures or accounting
138 methods, as testified to by Mr. McCarthy (Joint Applicants' Exhibit 1.0, p. 32).

139 In addition, I recommend that Frontier be subject to the following conditions as
140 further evidence of compliance with Section 7-204(b)(3):

- 141 1. Commission Staff will be granted access to all books, accounts, records
142 and personnel of Frontier and all of their utility and non-utility affiliated
143 sister and subsidiary companies, as well as independent auditor's working
144 papers, to the extent permitted by the rules and policies of the
145 independent auditor;
- 146 2. Frontier will continue to comply with 83 Ill. Admin. Code 711, Cost
147 Allocation Rules for Large Local Exchange Carriers; and

148 3. Frontier will conduct an annual internal audit to test compliance with
149 Section 7-204(b)(2) and 7-204(b)(3). The internal audit report will be
150 submitted to the Manager of Accounting of the Commission by March 31st
151 of each year and associated working papers will be available to
152 Commission Staff for review.

153 The purpose of the internal audit will be to document the procedures
154 performed and conclusions to determine that cost allocations between
155 regulated and non-regulated activities are in compliance with Frontier's
156 cost allocation manual filed with the Commission and that the cost
157 allocation manual is correct and complete.
158

159 **Q. Please explain your rationale for the frequency of the submission of an**
160 **internal audit report and the objective of such internal audit.**

161 A. The Commission currently requires that internal audits be performed on a routine
162 annual basis to insure that there is no cross subsidization of non-regulated
163 operations by the regulated operations of Illinois public utilities.

164 I propose that the Commission Order should include this condition as written
165 above. The description should indicate the purpose of the internal audit so that
166 there is no ambiguity as to what the internal audit should achieve. The internal
167 audit should document the procedures performed and conclusions to determine
168 that cost allocations between regulated and non-regulated activities are in
169 compliance with Frontier's cost allocation manual that is filed with the
170 Commission and that the cost allocation manual is correct and complete.

171

172 **Q. What is your recommendation regarding the finding the Commission must**
173 **make regarding compliance with Section 7-204(b)(3)?**

174 A. I recommend that Frontier be subject to the above conditions in order for the
175 Commission to find that the costs and facilities of Frontier will be fairly and
176 reasonably allocated between utility and non-utility activities in such a manner
177 that the Commission will be able to identify those costs and facilities that are
178 properly included for ratemaking purposes in compliance with Section 7-
179 204(b)(3), to the extent feasible in the telecommunications industry today.

180

181 **Finding Regarding Section 7-204(c)**

182 **Q. Describe the ruling the Commission must make to be in compliance with**
183 **Section 7-204(c).**

184 A. The Commission shall not approve a reorganization without ruling on 1) the
185 allocation of any savings resulting from the proposed reorganization; and 2)
186 whether the companies should be allowed to recover any costs incurred in
187 accomplishing the proposed reorganization and, if so, the amount of costs
188 eligible for recovery and how the costs will be allocated.

189

190 **Q. How does Frontier propose to allocate any savings resulting from the**
191 **proposed reorganization?**

192 A. Frontier has estimated \$500 million in annual savings on a company-wide basis
193 being realized in 2013 with lesser amounts to be expected in earlier years (Staff
194 Data Request JZ 2.07). According to the Joint Applicants, savings on an Illinois-
195 specific basis have not been determined by Frontier and the timing and actual
196 amount of any such savings in Illinois would be speculative at this point in time

197 (Joint Applicants' Exhibit 1.0, p. 41). Frontier believes that any savings allocated
198 to regulated intrastate local exchange services will be offset by the investment to
199 upgrade the acquired network facilities (Joint Applicants' Exhibit 1.0, p. 42), used
200 towards investment in a greater availability of services, including broadband, and
201 will offset revenue losses associated with lost access lines (Staff Data Request
202 JZ 3.02).

203

204 **Q. Do you agree with the Company's proposal on the allocation of any**
205 **savings resulting from the proposed reorganization?**

206 A. The Company appears to be saying that what savings are allocated to the
207 regulated intrastate jurisdiction would reduce costs when setting rates for the
208 regulated intrastate jurisdiction. The issue that may arise in that proceeding to
209 set rates would be the allocation methodology to be used to allocate the savings
210 to the regulated intrastate jurisdiction. This issue would be litigated in that
211 proceeding.

212

213 **Q. Are the Joint Applicants proposing to be allowed to recover any costs**
214 **incurred in accomplishing the proposed reorganization?**

215 A. Mr. McCarthy testified that the Joint Applicants are not seeking in this
216 proceeding, nor will they seek in any other proceeding, to recover any costs
217 Frontier may incur in accomplishing the proposed reorganization (Joint
218 Applicants' Exhibit 1.0, p. 42).

219

220 **Q. Do you agree with the Joint Applicant's proposal for the recovery of any**
221 **costs associated in accomplishing the proposed reorganization?**

222 A. Yes.

223

224 **Q. What is your recommendation regarding the ruling the Commission must**
225 **make regarding Section 7-204(c)?**

226 A. I recommend that the Commission rule that: (1) the allocation of any savings
227 resulting from the proposed reorganization would flow through to the costs
228 associated with the regulated intrastate operations for consideration in setting
229 rates by the Commission; and (2) the Joint Applicants will not be allowed to
230 recover any costs incurred in accomplishing the proposed reorganization in
231 future rate proceedings.

232

233 **Conclusion**

234 **Q. Does this question end your direct testimony?**

235 A. Yes.