Docket 09-0268
ICC Staff Exhibit 3.0

DIRECT TESTIMONY

OF

ROCHELLE PHIPPS

FINANCE DEPARTMENT

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 A REORGANIZATION
PURSUANT TO SECTION 7-204 OF
THE PUBLIC UTILITIES ACT

DOCKET NO. 09-0268

OCTOBER 20, 2009

Q. Please state your name and business address.

A. My name is Rochelle Phipps. My business address is 527 East Capitol Avenue, Springfield, IL 62701.

Q. What is your current position with the Illinois Commerce Commission ("Commission")?

A. I am a Senior Financial Analyst in the Finance Department of the Financial Analysis Division of the Illinois Commerce Commission ("Commission").

Q. Please describe your qualifications and background.

A. I received a Bachelor of Arts degree in Finance from Illinois College, Jacksonville, Illinois. I received a Master of Business Administration degree from the University of Illinois at Springfield. I have been employed by the Commission since June 2000.

Q. What is the purpose of your testimony?

A. Frontier Communications Corporation ("Frontier"), Verizon Communications, Inc. ("Verizon"), Verizon North, Inc. ("Verizon North"), Verizon South, Inc. ("Verizon South") and New Communications of the Carolinas, Inc. ("NewILEC") (the "Joint Applicants") request approval of a transaction in which Frontier would acquire the local exchange operations of Verizon North and Verizon South in Illinois. Frontier will continue to operate the local exchange operations of Verizon North and Verizon South as two separate operating companies named Frontier North, Inc. and Frontier Communications of the Carolinas, Inc., respectively (the "New Frontier ILECs"). I will present my evaluation of the financial implications of the proposed reorganization on the New Frontier ILECs under Sections 7-204(b)(4) and 6-103 and of the Public Utilities Act ("Act"). Pursuant to Section 7-204(b)(4) of the Act, the Commission must find that "the proposed reorganization will not significantly impair the utility's ability to raise necessary capital on reasonable terms or to maintain a reasonable capital structure."[1] The capitalization of a public utility formed by a merger or consolidation of two or more corporations is subject to Commission approval under Section 6-103 of the Act.[2]

Q. Please summarize your findings and recommendations.

A. I recommend that the Commission place two conditions on approval of the proposed reorganization to assure that it will not significantly impair the New Frontier ILEC's ability to raise necessary capital on reasonable terms or to maintain a reasonable capital structure. I recommend these two conditions for the following reasons:

[1] 220 ILCS 5/7-204.
[2] 220 ILCS 5/6-103.

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

2. Frontier's ability to raise necessary capital on reasonable terms is questionable.

3. However, in my judgment, Frontier's ability to raise necessary capital on reasonable terms is not a necessary factor for meeting the criteria specified in Section 7-204(b) because the Illinois operations of the New Frontier ILECs[3] internally generate sufficient cash to fund the expenditures necessary to meet service standards. Thus, if the New Frontier Illinois ILECs retain a portion of the cash they generate sufficient for maintaining adequate service, an external source of capital is unnecessary because they will have "the ability to raise necessary capital" within the meaning of Section 7-204(b)(4).

4. Given the New Frontier Illinois ILECs are expected to generate internally sufficient cash flow to meet service standards, I recommend two conditions to ensure that maintenance of service quality has a higher claim to the New Frontier Illinois ILECs'

[3] Hereafter referred to as "New Frontier Illinois ILECs."

internally generated cash flow than the financial needs of their affiliates.

Furthermore, I recommend the Commission adopt three reporting requirements that will inform the Commission of how the Joint Applicants finance the proposed reorganization and changes to Frontier's credit ratings, capital structure and cost of capital following the proposed reorganization. Attachment 1 presents the two conditions and three reporting requirements that I recommend for the New Frontier ILECs.

Finally, I recommend that the Joint Applicants provide the Commission sufficient information to make a determination under Section 6-103 of the Act.[4]

Q. Please describe the proposed reorganization.

A. Pursuant to a Distribution Agreement,[5] Verizon will transfer certain of its incumbent local exchange companies ("ILECs") to New Communications Holdings, Inc. ("NCH," which is referred to as "Spinco" in the Distribution and Merger Agreements), a newly created subsidiary of Verizon, formed solely for the proposed reorganization. With respect to the Illinois Verizon properties, Verizon will transfer Verizon South's local exchange operations to New Communications of the Carolinas, Inc. ("NewILEC"), a direct

[4] 220 ILCS 5/6-103.

[5] Distribution Agreement by and between Verizon Communications, Inc. and New Communications Holdings, Inc., dated as of May 13, 2008. (Joint Application Exhibit 2)

subsidiary of New Communications ILEC Holdings, Inc. ("NCIH"), and an indirect subsidiary of NCH. Verizon will also transfer Verizon North to NCIH. Verizon will distribute NCH stock to Verizon shareholders in exchange for a $3.333 billion payment comprising cash and debt relief.

Immediately following the spin-off of NCH stock to Verizon shareholders, NCH will merge into Frontier, and Verizon shareholders will receive newly issued shares of Frontier valued at approximately $5.247 billion. Pursuant to a Merger Agreement,[6] Frontier will acquire NCH, including Verizon North and NewILEC, and continue to operate those properties as two separate Illinois local exchange companies named Frontier North, Inc. and Frontier Communications of the Carolinas, Inc., respectively (the "New Frontier ILECs").

Q. Please describe the $3.33 billion contribution from NCH to Verizon.

A. Pursuant to Section 2.4 of the Distribution Agreement, NCH will issue debt and use the proceeds to pay Verizon an amount that equals the lesser of (x) $3.33 billion and (y) Verizon's estimate of its tax basis in NCH <u>minus</u> the outstanding long-term debt of NCH and its subsidiaries on the distribution date ("Distribution Date Spinco Indebtedness").[7] This payment

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[6] Agreement and Plan of Merger, dated as of May 13, 2009, by and among Verizon Communications Inc., New Communications Holdings Inc. and Frontier Communications Corporation. (Joint Application Exhibit 1)

[7] Assuming a closing date of March 31, 2010, the total principal amount of Distribution Date Spinco Indebtedness would be $425 million and assuming a closing date after June 1, 2010, the total principal amount of Distribution Date Spinco Indebtedness would be $250 million. Joint Applicants' response to ICC Staff data request RP 2.02.

from NCH to Verizon is the "Special Payment" and the related debt issued by NCH (which will become Frontier's debt obligation following the merger) is the "Special Payment Financing." If the Special Payment is less than $3.33 billion, then NCH will issue "Spinco Securities" to Verizon, in an amount equal to such difference.

Pursuant to Section 7.18 of the Merger Agreement, Frontier is not obligated to accept the Special Payment Financing nor, if applicable, the Spinco Securities under any of the following circumstances:

- Either the weighted-average life of the financing and the securities, together with Distribution Date Spinco Indebtedness, is less than five years, or any of the Special Payment financing or the Spinco Securities would have a final maturity of earlier than January 1, 2014 (other than bridge financing up to $600 million);

- The financing or the securities or the Distribution Date Spinco Indebtedness would be secured by assets of any operating company;

- The terms or provisions of such financing or securities or Distribution Date Spinco Indebtedness would be prohibited by or result in a default under Frontier's existing credit agreements or indentures;

- The proposed covenants and other terms and conditions (excluding the terms of Spinco Securities set forth in Exhibit G of the Distribution Agreement and the rate, yield or tenor thereof) are not substantially in accordance with prevailing market terms for similarly sized loan bank borrowings or capital issuances by companies similar in size and credit ratings to Frontier and the effect of such covenants and provisions would be materially adverse to post-merger Frontier; or

- The weighted-average annual cash interest rate of the Special Payment Financing, the Spinco Securities and the Distribution Date Spinco Indebtedness exceeds 9.5% (unless Frontier determines a higher rate would not be unduly burdensome).

At this time, Frontier has not obtained financing commitments from lenders.[8] Since the Joint Applicants are seeking Commission approval of the proposed reorganization, they should be required to notify the Commission of the exact terms of the Special Payment Financing and Spinco Securities that the Joint Applicants issue in connection with the proposed reorganization. Therefore, I recommend the Commission adopt the following reporting requirement ("Reporting Requirement 1"):

> Frontier North, Inc. and Frontier Communications of the Carolinas, Inc. shall file with the Chief Clerk of the Commission copies of all documents relating to the Special Payment Financing and any Spinco Securities issued pursuant to the Distribution Agreement and the Merger Agreement within 10 days of the merger agreement's execution. The documents shall be posted in this docket.

Q. In your judgment, will the proposed reorganization significantly impair the utilities' ability to raise necessary capital on reasonable terms?

A. The New Frontier Illinois ILECs currently generate more cash than they require for capital expenditures.[9] In the event the New Frontier Illinois ILECs need additional funds to support capital expenditures, Frontier would provide capital to the operating companies through either inter-company loans or capital infusions.[10] Frontier asserts that it will access capital markets utilizing the issuance of public bonds and bank term

[8] Joint Applicants' response to data request IBEW 1.22.
[9] Joint Applicants' response and supplemental response to ICC Staff data request RP 3.01.
[10] Joint Applicants' supplemental response to ICC Staff data request RP 1.16.

loans.[11] As shown on the table below, Verizon's credit ratings are five to six notches higher than Frontier's ratings. As such, it will be more challenging for Frontier to raise capital for the New Frontier ILECs than it would be for Verizon.

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

Q. Please describe your concerns regarding Frontier's financial strength as it pertains to the New Frontier ILECs' ability to provide reasonable and adequate service at reasonable cost.

A. Frontier has an issuer rating of "Ba2" from Moody's Investors Service ("Moody's"), "BB" from Standard & Poor's ("S&P") and Fitch Ratings.[12]

[11] Joint Applicants' response to ICC Staff data request RP 2.05.

[12] Moody's Investors Service, "Rating Action: Frontier's ratings on review for possible upgrade; Verizon – NW, North and WV on review for possible downgrade," May 13, 2009 (Joint Applicants' response to ICC Staff data request RP 1.01); S&P Research Update, "Frontier Communications 'BB' Corporate Credit Rating Affirmed Following Proposed Acquisition of Verizon Access Lines," May 13, 2009 (Joint Applicants' response to ICC Staff data request RP 1.06); and Fitch Ratings, "Fitch Places Frontier Communications on Rating Watch Positive," May 13, 2009 (Joint Applicants' response to ICC Staff data request RP 1.05).

That is, Frontier's current issuer credit ratings are two rating notches below the minimum investment grade credit rating of Baa3/BBB-/BBB-. According to Moody's: "[o]bligations rated Ba are judged to have speculative elements and are subject to substantial credit risk."[13] Similarly, S&P states:

> An obligation rated BB is less vulnerable to nonpayment than other speculative issuers. However, it faces major ongoing uncertainties or exposure to adverse business, financial or economic conditions which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation.[14]

Q. How is the proposed reorganization expected to affect Frontier's credit rating?

A. Frontier notes that, "two credit rating agencies (Moody's and Fitch) put Frontier on a positive credit watch the day the proposed transaction was announced, thereby suggesting Frontier's credit rating may improve following the closing of the transaction, based upon the projected capital structure."[15] However, in a report I have attached as Attachment 2, Fitch Ratings states an upgrade may be limited to one notch "due to the ever-present integration risks in large telecom transactions and lower near-term financial flexibility as the company incurs integration costs, invests to

[13] *Moody's Rating Symbols and Definitions,* www.moodys.com.
[14] Standard & Poor's, "Research: Standard & Poor's Ratings Definitions," December 10, 2002.
[15] Joint Applicants' Exhibit 1, p. 36.

expand broadband availability and only begins to realize synergies."[16] That is, Frontier attaining investment grade ratings following the proposed reorganization is questionable. Therefore, even after the proposed reorganization, Frontier's financial condition might not be sufficiently strong to eliminate concerns about its capacity to meet its debt servicing obligations during adverse conditions without transferring cash from New Frontier ILECs that is necessary for maintaining the New Frontier ILECs' service quality.

Q. Is Frontier's management of the integration of the New Frontier ILECs an important factor in Moody's and Standard & Poor's assessments of Frontier's creditworthiness?

A. Yes. Moody's and S&P state that Frontier's ability to manage its post-merger capital structure and operations successfully will be key drivers of Frontier's post-merger credit rating. Specifically, Moody's notes:

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

[16] Fitch Ratings, "Fitch Rates Frontier's Proposed $450MM Debt Offering 'BB'; Remains on Watch Positive," September 17, 2009.

> telecommunications company and the continuing downward pressure on its revenue and cash flow.[17]

Similarly, S&P states:

> Standard & Poor's expects the integration of the Verizon properties will be challenging given the size of the transaction…we are concerned that execution missteps or deteriorating operating trends could result in higher leverage in the intermediate term…Potential operating synergies are meaningful at about $500 million…but achieving this will require solid execution during the integration and may be impeded by higher access-line losses or a more competitive industry environment.[18]

Q. Do you have any recommendation to address your concern about the effect of the acquisition and integration of the New Frontier ILECs on Frontier's credit rating?

A. Yes. Given the ratings agencies' concerns regarding Frontier's ability to successfully manage this reorganization, I recommend that the Commission adopt the following reporting requirement ("Reporting Requirement 2"):

> Following the proposed reorganization, Frontier North, Inc. and Frontier Communications of the Carolinas, Inc. shall file with the Chief Clerk of the Commission and the manager of the Finance Department all credit rating reports published by Moody's Investors Service, Standard & Poor's and Fitch Ratings relating to changes in Frontier Communications Corporation's (and any of its affiliates' and subsidiaries') ratings outlooks or credit ratings within 10 days of their publication. Such reports shall be posted in this docket.

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[17] Moody's Investors Service, "Rating Action: Moody's assigns Ba2 rating to Frontier's notes; ratings remain on review for upgrade," September 17, 2009. The complete report is attached as Attachment 3.

[18] Standard & Poor's Research Update, "Frontier Communications Corp. Senior Unsecured Notes Rated 'BB' (Recovery: 3); 'BB' Rating Affirmed," September 17, 2009. The complete report is attached as Attachment 4.

Q. What are potential consequences of speculative credit ratings?

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

FairPoint Communications, Inc. ("FairPoint") acquired certain Verizon assets and operations on March 31, 2008, in a very similar transaction to the Joint Applicants' proposed reorganization. The FairPoint / Verizon transaction is an example of the potential consequences of the nexus of merger integration and speculative credit ratings. In seeking Commission approval of the transaction, in Docket No. 07-0191, the petitioners stated that transaction would make FairPoint a financially stronger company with an improved capital structure. Moreover, S&P expected the transaction to make FairPoint modestly stronger and, consequently, placed FairPoint's "BB-" rating on CreditWatch with positive implications.[19] Prior to the merger, FairPoint's credit ratings from S&P, Moody's and Fitch Ratings were BB/B1/BB-.[20] Today, FairPoint's credit ratings from S&P, Moody's and Fitch Ratings are D/Caa3/C, which signals Fairpoint has defaulted or a default is imminent.

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19 Order, Docket No. 07-0191, June 27, 2007, pp. 7 and 10.

20 Standard & Poor's, www.standardandpoors.com; Moody's Investors Service, www.moodys.com; and Fitch Ratings, www.fitchratings.com.

Q. Please describe Frontier's pro forma analysis of the effects of the proposed reorganization on its financial metrics.

A. Frontier asserts:

> Not only will Frontier continue to be financially strong following the closing of the proposed Verizon transaction, its financial position will be improved. By deleveraging its balance sheet and by decreasing both its per-share dividend payout and dividend payout ratio, Frontier will emerge from this transaction as a stronger, more stable competitor with a financial structure and level of cash flow that will enable it to make investments in the acquired service territories, including in broadband, and to provide even more efficient service in these areas.[21]

Frontier prepared revenue, expense, earnings before interest, taxes, depreciation and amortization ("EBITDA") and cash flow projections for the post-merger company through 2014, which assume $500 million savings annually due to synergies. Frontier did not perform any pro forma analysis assuming zero synergies.[22] I examined the sensitivity of Frontier's financial strength to synergies Frontier assumes will occur with respect to Verizon's Standalone Telephone Operations ("West Standalone").[23] Specifically, I substituted actual 2008 operating expenses and capital expenditures for West Standalone in place of Frontier's projections for West Standalone. I did not adjust the pro forma projections for Standalone Frontier. I calculated the following pro forma financial metrics for the

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[21] Joint Applicants' Exhibit 1, p. 34.

[22] Joint Applicants' response to IBEW data request 5.34.

[23] An assessment of the accuracy of Frontier's estimate of synergies is beyond the scope of my testimony. My analysis examines the sensitivity of Frontier's financial strength to synergies only.

combined entity using Frontier's pro forma analysis and my adjusted pro forma analysis: (1) EBITDA margin; (2) Debt to EBITDA; (3) Free cash flows ("FCF") to debt; (4) Retained cash flows ("RCF") to debt; (5) Funds from operations interest coverage ("FFO Interest Coverage"); and (6) EBITDA less capital expenditures ("Capex") over interest expense.[24] Then, I compared Frontier's pro forma and my adjusted pro forma financial metrics to Moody's benchmarks for the global telecommunications industry, as presented in Attachment 5. Frontier's financial metrics are presented in the table below.

A Comparison of Frontier's Pro Forma Financial Metrics

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

This comparison shows Frontier's pro forma analysis, which assumes synergies totaling $500 million annually, produced investment grade financial metrics for 3 of the 6 ratios. In contrast, my adjustments, which remove those projected synergies that I could identify and assume going

[24] Moody's Global Corporate Finance, "Global Telecommunications Industry," December 2007.

forward capital expenditures will equal West Standalone's 2008 capital expenditures, produced investment grade financial metrics for only 1 of the 6 ratios. This analysis demonstrates that Frontier's post-merger financial strength depends on its ability to realize a significant portion of its projected synergies.

Q. What are the two conditions that you recommend the Commission adopt if it approves the Joint Applicants' proposed reorganization?

A. I recommend the following two conditions, which are also presented on Attachment 1:

<u>Condition 1:</u>

(a) Frontier North, Inc. and Frontier Communications of the Carolinas, Inc. (the "New Frontier ILECs") will be prohibited from paying dividends or otherwise transferring any Illinois jurisdictional cash balances to Frontier Communications Corporation or its affiliates through loans, advances, investment or other means that would divert the New Frontier Illinois ILECs' moneys, property or other resources that is not essentially or directly connected with the provision of noncompetitive telecommunications service if the New Frontier Illinois ILECs fail to meet or exceed the standards set forth below for a majority of the following service quality standards of 83 Illinois Administrative Code Part 730, Standards of Service for Local Exchange Telecommunications Carriers:

STANDARDS: (set forth in the Direct Testimony of ICC Staff witness Mr. Samuel McClerren)

In the event of failure, the Commission prohibits dividend payments or otherwise transferring cash from the Illinois jurisdictional accounts of New Frontier ILECs to the parent company or its affiliates until the next satisfactory annual report. It would be the Commission's expectation that Frontier Communications Corporation would make these funds available to the New Frontier ILECs to use these funds to improve its Illinois operations, not to simply wait for the condition to expire.

(b) MEASUREMENTS: Measurements shall commence on the date that the merger closes, and recur on an annual calendar year basis.

(c) ANNUAL REPORTS: Each of the New Frontier ILECs shall file an annual report with the Chief Clerk's Office and post such annual report in this docket. The annual report will be filed by February 1 of each year for the preceding year. Within the annual report, each of the New Frontier ILECs shall list the standard set by the Commission for each service quality measure and each of the New Frontier ILECs' actual performance for each annual period. The annual report shall present the actual performance data for every month after the date that the merger closes, with the initial month of data presented being the month in which the merger closes.

The annual report shall also include an Illinois jurisdictional free cash flow calculation for the twelve months ending December 31 of each year this Condition remains in effect. The Illinois jurisdictional free cash flow calculation shall be in the same format as Joint Applicants' supplemental response to ICC Staff data request RP 3.01 and include Verifications from the financial officers of the New Frontier ILECs.

(d) DURATION OF CONDITION: Condition (1) shall remain in effect until Frontier Communication Corporation's issuer credit rating is BBB from Standard & Poor's, Baa2 from Moody's Investors Service and BBB from Fitch Ratings.

<u>Condition 2:</u>

Through a combination of available cash and availability under credit agreements with external financial institutions, Frontier Communications Corporation shall keep available exclusively for Illinois operations of Frontier North, Inc. and Frontier Communications of the Carolinas, Inc. (the "New Frontier ILECs"), an aggregate amount equal to the higher of $50 million or the currently approved capital expenditure budget for the Illinois operations of the New Frontier ILECs. Frontier Communications Corporation shall certify annually to the Commission that the required amount is available for Illinois operations of the New Frontier ILECs for the ensuing year. Therefore, on December 1 of each year, Frontier Communications Corporation shall file a notice with the Commission certifying that such amount is currently available and the amount of dollar commitment for the New Frontier ILECs' Illinois operations for the following year, based on their capital expenditures budget for the following year, but in no event less than $50 million.

Q. Would your proposed conditions ensure that the New Frontier Illinois ILECs maintain sufficient funds to support Illinois operations?

A. Yes. Should the New Frontier Illinois ILECs fail to pass the service quality test described in Condition 1, then those companies would be prohibited from paying dividends or otherwise transferring Illinois jurisdictional cash balances to Frontier or its affiliates through loans, advances, investments or other means that would divert its moneys, property or other resources to any purpose that is not essentially or directly connected with the provision of non-competitive telecommunication service. Frontier would continue to have access to any funds that the New Frontier Illinois ILECs generate in excess of the amount needed to meet the service quality standards. Additionally, Condition 2 would require Frontier to reserve funds, exclusively for the Illinois operations of the New Frontier ILECs, in an aggregate amount equal to the higher of $50 million or the currently approved capital expenditure budget of the New Frontier Illinois ILECs. With this condition in place, the proposed reorganization would not significantly impair the New Frontier ILECs' ability to raise *necessary* capital on reasonable terms.

Q. What is the basis for the $50 million threshold for Condition 2?

A. Verizon's average annual capital expenditures in Illinois for years 2006 through 2008 equals approximately $50 million.[25] Frontier anticipates spending more in capital expenditures on a nationwide basis than the historical amounts Verizon spent on the lines Frontier will acquire.[26] On this basis, the historical amounts that Verizon spent would serve as a minimum threshold to avoid unnecessarily limiting Frontier's investment in the New Frontier Illinois ILECs.

Q. Will the proposed reorganization significantly impair the utility's ability to maintain a reasonable capital structure?

A. Frontier expects its debt ratio to decrease from 91% to 58% following the proposed reorganization.[27] All else equal, a lower debt to capitalization ratio signifies lower financial risk. Towards that end, Frontier expects its weighted average cost of capital to fall to 9.13% from 9.91% following the proposed reorganization.[28]

Although Frontier and the ratings agencies speculate that the proposed reorganization will enhance Frontier's capital structure, the final capital structure of the merged entity has not yet been finalized.[29] Therefore, I recommend the Joint Applicants notify the Commission of their post-

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[25] Joint Applicants' response to IBEW data request 3.3.
[26] Joint Applicants' response to IBEW data request 2.21.
[27] Joint Applicants' responses to ICC Staff data requests RP 1.13 and RP 1.14.
[28] Joint Applicants' responses to ICC Staff data requests RP 1.13 and RP 1.14.
[29] Joint Applicants' response to ICC Staff data request RP 1.16.

merger capital structure and cost of capital, as required in the following reporting requirement ("Reporting Requirement 3"):

> Frontier North, Inc. and Frontier Communications of the Carolinas, Inc. shall file with the Chief Clerk of the Commission a statement describing the post-merger capital structure and overall cost of capital of Frontier North, Inc., Frontier Communications of the Carolinas, Inc. and Frontier Communications Corporation. The statement shall be posted in this docket.

Q. Please summarize your conclusions.

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

Further, the reduction in the proportion of debt in Frontier's post-merger capital structure, from its current level, should enhance Frontier's ability to raise further capital on reasonable terms should the need arise.

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

The second part of Section 7-204(b)(4) of the Act requires the Commission to find that the proposed reorganization will not impair the utility's ability to maintain a reasonable capital structure. I interpret "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. New Frontier ILECs would not independently raise capital. Under that circumstance, the Commission typically uses a parent company's capital structure to set rates. The proposed reorganization would reduce the proportion of debt in Frontier's capital structure, although that reduction in debt is unlikely to be sufficient for it to attain investment grade credit ratings. From this standpoint, the proposed reorganization cannot be deemed to result in a reasonable capital structure but can be deemed to enhance the ability of Frontier, and through Frontier, the ability of New Frontier ILECs, to achieve a reasonable capital structure.

In summary, the proposed reorganization will not significantly impair New Frontier Illinois ILEC's ability to raise necessary capital on reasonable terms or to maintain a reasonable capital structure, if the New Frontier

ILECs comply with the conditions and reporting requirements set forth herein.

Finally, the Joint Applicants should provide the Commission sufficient information to make a determination regarding the post-merger capitalization, as required under Section 6-103 of the Act.

Q. Does this conclude your direct testimony?

A. Yes, it does.

Staff's Recommended Conditions and Reporting Requirements

I recommend the following conditions, which are designed to ensure that the New Frontier ILECs devote sufficient cash they generate from operations to meet the service standards set forth in the testimony of Staff witness Mr. Samuel S. McClerren.

Condition 1:

(a) Frontier North, Inc. and Frontier Communications of the Carolinas, Inc. (the "New Frontier ILECs") will be prohibited from paying dividends or otherwise transferring any Illinois jurisdictional cash balances to Frontier Communications Corporation or its affiliates through loans, advances, investment or other means that would divert the New Frontier Illinois ILECs' moneys, property or other resources that is not essentially or directly connected with the provision of noncompetitive telecommunications service if the New Frontier Illinois ILECs fail to meet or exceed the standards set forth below for a majority of the following service quality standards of 83 Illinois Administrative Code Part 730, Standards of Service for Local Exchange Telecommunications Carriers:

STANDARDS: (set forth in the Direct Testimony of ICC Staff witness Mr. Samuel McClerren)

In the event of failure, the Commission prohibits dividend payments or otherwise transferring cash from the Illinois jurisdictional accounts of New Frontier ILECs to the parent company or its affiliates until the next satisfactory annual report. It would be the Commission's expectation that Frontier Communications Corporation would make these funds available to the New Frontier ILECs to use these funds to improve its Illinois operations, not to simply wait for the condition to expire.

(b) MEASUREMENTS: Measurements shall commence on the date that the merger closes, and recur on an annual calendar year basis.

(c) ANNUAL REPORTS: Each of the New Frontier ILECs shall file an annual report with the Chief Clerk's Office and post such annual report in this docket. The annual report will be filed by February 1 of each year for the preceding year. Within the annual report, each of the New Frontier ILECs shall list the standard set by the Commission for each service quality measure and each of the new Frontier Illinois operating company's actual performance for each annual period. The annual report shall present the actual performance data for every month after the date that the merger closes, with the initial month of data presented being the month in which the merger closes.

The annual report shall also include an Illinois jurisdictional free cash flow calculation for the twelve months ending December 31 of each year this Condition remains in effect. The Illinois jurisdictional free cash flow calculation shall be in the same format as Joint Applicants' supplemental response to ICC Staff data request RP 3.01 and include Verifications from the financial officers of the New Frontier ILECs.

(d) DURATION OF CONDITION: Condition (1) shall remain in effect until Frontier Communication Corporation's issuer credit rating is BBB from Standard & Poor's, Baa2 from Moody's Investors Service and BBB from Fitch Ratings.

Condition 2:

Through a combination of available cash and availability under credit agreements with external financial institutions, Frontier Communications Corporation shall keep available exclusively for Illinois operations of Frontier North, Inc. and Frontier Communications of the Carolinas, Inc. (the "New Frontier ILECs"), an aggregate amount equal to the higher of $50 million or the currently approved capital expenditure budget for the Illinois operations of the New Frontier ILECs. Frontier Communications Corporation shall certify annually to the Commission that the required amount is available for Illinois operations of the New Frontier ILECs for the ensuing year. Therefore, on December 1 of each year, Frontier Communications Corporation shall file a notice with the Commission certifying that such amount is currently available and the amount of dollar commitment for the New Frontier ILECs' Illinois operations for the following year, based on their capital expenditures budget for the following year, but in no event less than $50 million.

I also recommend the following reporting requirements that will inform the Commission of how the Applicants finance the proposed reorganization and changes to Frontier's credit ratings following the proposed reorganization.

Reporting Requirement 1:

Frontier North, Inc. and Frontier Communications of the Carolinas, Inc. shall file with the Chief Clerk of the Commission copies of all documents relating to the Special Payment Financing and any Spinco Securities issued pursuant to the Distribution Agreement and the Merger Agreement within 10 days of the merger agreement's execution. The documents shall be posted in this docket.

Reporting Requirement 2:

Following the proposed reorganization, Frontier North, Inc. and Frontier Communications of the Carolinas, Inc. shall file with the Chief Clerk of the Commission and the manager of the Finance Department all credit rating reports published by Moody's Investors Service, Standard & Poor's and Fitch Ratings relating to changes in Frontier Communications Corporation's (and any of its affiliates' and subsidiaries') ratings outlooks or credit ratings within 10 days of their publication. Such reports shall be posted in this docket.

Reporting Requirement 3:

Frontier North, Inc. and Frontier Communications of the Carolinas, Inc. shall file with the Chief Clerk of the Commission a statement describing the post-merger capital structure and overall cost of capital of Frontier North, Inc., Frontier Communications of the Carolinas, Inc. and Frontier Communications Corporation. The statement shall be posted in this docket.

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FITCH RATES FRONTIER'S PROPOSED $450MM DEBT OFFERING 'BB'; REMAINS ON WATCH POSITIVE

Fitch Ratings-Chicago-17 September 2009: Fitch Ratings has assigned a 'BB' rating to Frontier Communications Corporation's (Frontier) (NYSE: FTR) proposed offering of $450 million of senior unsecured debt due 2018. Frontier's Issuer Default Rating (IDR) is 'BB', and its ratings were placed on Rating Watch Positive owing to its proposed transaction with Verizon Communications Inc. (Verizon) (NYSE: VZ) on May 13, 2009.

Frontier plans to the use the proceeds from the proposed offering and existing cash to tender for up to $700 million of debt. The tender will be prioritized, and debt subject to the tender includes any or all of its approximately $641 million of 9.25% senior unsecured notes maturing in 2011, as well as a portion of its $700 million of senior unsecured 6.25% notes maturing in 2013. The acceptance of the 2013 notes tendered and not withdrawn is conditioned upon the tender of any and all 2011 notes tendered and not withdrawn.

Frontier's 'BB' rating reflects its strong operating margins and access to ample liquidity. Its core rural telecommunications operations are facing a slow but relatively stable state of decline due to continued pressure of competition and the recessionary economy. The company has been mitigating the effect of access line losses to cable operators and wireless providers through the marketing of additional services, including high-speed data, and through cost controls.

Fitch anticipates that Frontier's gross debt to EBITDA at year end 2009 will be in the 4.0 times (x) to 4.2x range, slightly higher than the 3.9x recorded at year end 2008, due to pressure on EBITDA arising from recessionary and competitive induced effects, as well as higher non-cash pension expenses, severance costs and costs related to the acquisition. Gross leverage on June 30, 2009 was approximately 4.3x on a last 12-month (LTM) basis, as only $308 million of the proceeds from its $600 million April 2009 debt offering had been used to reduce debt in the second quarter. Cash remaining from the April offering is expected to be deployed in the proposed tender offer.

In the Verizon transaction, Frontier will merge with a separate company formed by certain Verizon local exchange assets in 14 states (consisting of approximately 4.5 million access lines) in a tax-free transaction to create a large local exchange company. The transaction remains subject to regulatory and shareholder approvals.

As a result of the potential positive effects of the Verizon transaction on Frontier's credit profile, Fitch placed the company's 'BB' IDR and other ratings on Rating Watch Positive. The company to be merged into Frontier will be moderately levered, and on a 2008 pro forma basis, the post-merger company would have had leverage of 2.6x, based on net debt of $8 billion and EBITDA, excluding $500 million in anticipated synergies, of $3.1 billion. Following the close of the transaction, Frontier will reduce is per share dividend to $0.75 from $1 to improve financial flexibility.

The close of the transaction is expected in the second quarter of 2010. Year end 2010 credit metrics are expected to significantly improve from Frontier's current levels, and its leverage metric is expected be in the 'BBB-' range (less than 3.0x). However, an upgrade may initially be limited to one notch due to the ever-present integration risks in large telecom transactions and lower near-term financial flexibility as the company incurs integration costs, invests to expand broadband availability and only begins to realize synergies. Due to the latter factors, Fitch believes Frontier's immediate post-close dividend payout will exceed the 55% payout (of pre-dividend free cash flows) Fitch views as the threshold for a rural local exchange carrier to remain investment grade. Fitch currently believes there could be additional positive rating momentum once the integration costs and broadband expansion spending are largely behind the company and material progress on achieving synergies occurs.

Frontier's ample liquidity is derived from its cash balances, free cash flow, and its revolving credit facility. On June 30, 2009, Frontier had $454 million in cash and for the LTM ending June 30, 2009, free cash flow was approximately $144 million. Fitch believes 2009 free cash flow could be within the range of the $133 million generated in 2008, based on the net effect of lower capital spending and higher cash taxes. Frontier's expectations for 2009 capital spending range from $250 million to $270 million, down from approximately $275 million in 2008; the company expects cash taxes to range from $90 million to $100 million in 2009, up from $79 million in 2008.

In addition to its cash balances and free cash flow, liquidity is provided by an undrawn $250 million five-year credit facility, which expires May 2012. The facility will be available for general corporate purposes but may not be used to fund dividend payments. As of June 30, 2009, Frontier had approximately $1.9 million in debt maturing in the last six months of 2009, $7.2 million due in 2010 and approximately $870 million in 2011.

Contact: John Culver, CFA +1-312-368-3216 or David Peterson +1-312-368-3177, Chicago.

Media Relations: Cindy Stoller, New York, Tel: +1 212 908 0526, Email: cindy.stoller@fitchratings.com.

Moody's Investors Service

Rating Action: **Moody's assigns Ba2 rating to Frontier's notes; ratings remain on review for upgrade**

Global Credit Research - 17 Sep 2009

New York, September 17, 2009 -- Moody's Investors Service has assigned a Ba2 rating to Frontier Communications Company's ("Frontier" or "the Company") proposed $450 million senior unsecured notes to be issued under its shelf registration, and placed the rating under review for upgrade. The company is likely to use the proceeds from the notes issuance largely to prefund near-term debt maturities. Frontier's ratings, including the Ba2 corporate family rating, remain on review for possible upgrade pending the completion of the planned merger with a company to be spun out of Verizon Communications' northern and western operations (VZ-Spinco) in a reverse Morris Trust transaction. Frontier's SGL1 short term liquidity assessment remains unchanged.

Ratings actions include the following:

$450 million new Senior Unsecured notes -- Assigned Ba2 (LGD4-56%), placed under review for possible upgrade.

Moody's review of Frontier's ratings is focused on the final capital structure of the combined entity following the merger, the substantial challenge Frontier faces in integrating a company more than twice its size, the regulatory framework and conditions placed on the merger, and most importantly, progress in the operating systems transition. Moody's will also assess management's commitment and ability to maintain an investment grade credit profile for the combined company in light of the intense competitive challenges confronting the sector and the resulting pressures to achieve the targeted cost savings.

Frontier's current Ba2 CFR reflects the company's relatively high debt levels for a wireline telecommunications company and the continuing downward pressure on its revenue and cash flow. Alternatively, the ratings and the outlook benefit from the stability of the Company's operations, and management's stated commitment to devote free cash flow to debt repayment and drive total debt-to-EBITDA leverage below 3.5x. Moody's recognizes that absent a transforming event, such as the acquisition of the VZ-Spinco properties, management is more likely to drive leverage to the high 3.0x levels, which is at the high end for a Ba2 wireline telecom issuer.

The principal methodology used in rating Frontier was that for Moody's Global Telecommunications Industry (December 2007, document #106465), which can be found at www.Moodys.com in the Rating Methodologies sub-directory, under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Ratings Methodologies sub-directory.

Moody's most recent rating action for Frontier was on May 13, 2009. At that time Moody's placed the Company's ratings on review for possible upgrade following the announcement of the VZ-Spinco transaction.

Frontier Communications (formerly Citizens Communications) is an RLEC providing wireline telecommunications services to approximately 2.3 million access lines in primarily rural areas and small- and medium-sized cities. The company is headquartered in Stamford, CT.

New York
Alexandra S. Parker
Managing Director
Corporate Finance Group
Moody's Investors Service
JOURNALISTS: 212-553-0376
SUBSCRIBERS: 212-553-1653

New York
Gerald Granovsky
VP - Senior Credit Officer

Corporate Finance Group
Moody's Investors Service
JOURNALISTS: 212-553-0376
SUBSCRIBERS: 212-553-1653

Moody's Investors Service

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Docket 09-0268

ICC Staff Exhibit 3.0

Attachment 4

Standard & Poor's Research Update:

Frontier Communications Corp. Senior Unsecured Notes Rated 'BB' (Recovery: 3); 'BB' Rating Affirmed

September 17, 2009

STANDARD
& POOR'S

RatingsDirect®

September 17, 2009

Research Update:

Frontier Communications Corp. Senior Unsecured Notes Rated 'BB' (Recovery: 3); 'BB' Rating Affirmed

Primary Credit Analyst:
Allyn Arden, CFA, New York (1) 212-438-7832;allyn_arden@standardandpoors.com

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Research Update:

Frontier Communications Corp. Senior Unsecured Notes Rated 'BB' (Recovery: 3); 'BB' Rating Affirmed

Overview

- We are assigning a 'BB' issue-level rating and a '3' recovery rating to Frontier's proposed $450 million of senior unsecured notes due 2018.
- We are affirming the 'BB' corporate credit rating on Frontier.
- The stable outlook reflects the company's moderate pro forma leverage, high margins, and solid net free cash flow generation, despite ongoing access line losses.

Rating Action

On Sept. 17, 2009, Standard & Poor's Ratings Services assigned a 'BB' issue-level rating to Stamford, Conn-based Frontier Communications Corp.'s proposed $450 million of senior unsecured notes due 2018, to be drawn from the company's shelf registration. Net proceeds, coupled with cash on hand, will be used to finance a cash tender offer to repurchase up to $700 million of existing debt, including maturities in 2011 and 2013. We also assigned a '3' recovery rating to the notes, which indicates expectations for meaningful (50% to 70%) recovery in the event of payment default.

At the same time, we affirmed all other ratings on Frontier, including the 'BB' corporate credit rating. The outlook is stable. The new notes will provide the company with a degree of financial flexibility, allowing it to extend maturities. However, we remain concerned about the company's access-line losses, which totaled 6.5% in the second quarter of 2009, as well as the integration of the acquired Verizon properties longer term.

Rationale

The ratings on Frontier continue to reflect rising competition from cable telephony and wireless substitution, the lack of a facilities-based video strategy, currently high leverage, and risk related to the acquisition of properties from Verizon Communications Inc. (A/Negative/A-1). Tempering factors include the company's solid position as an incumbent local exchange carrier (ILEC), primarily in less competitive rural areas; relatively stable cash flow and high margins; modest growth in high-speed data (HSD) services, which has helped mitigate revenue declines from line losses; and the deleveraging effect of the stock-based Verizon transaction.

Wireless substitution and cable telephony competition continue to pressure Frontier's existing customer base. Standard & Poor's believes the company will continue to face significant competition as cable operators keep deploying less expensive Internet protocol (IP) telephony service in rural markets. Frontier's overlap with cable telephone service is about 68% currently. Additionally, many consumers, especially in a weak economy, are eliminating wireline service altogether. Despite the company's promotional efforts to retain customers and some noticeable improvement in operating performance during the June 2009 quarter, we believe that access-line trends will remain under pressure in the foreseeable future.

In May 2009, Frontier announced that it had signed a definitive agreement with Verizon to acquire 4.8 million access lines in a stock-based transaction valued at approximately $8.6 billion. The acquisition of the Verizon properties will create a company that is about three times the size of Frontier on a stand-alone basis with around 7 million access lines in 27 states, which should improve Frontier's scale and diversify its footprint. However, the legacy Verizon markets have about 70% of its access line base in rural areas, with an average of 37 access lines per square mile, significantly higher than for stand-alone Frontier, which suggests that competition could increase and line losses could accelerate in these markets in the near term. HSD penetration in the legacy Verizon markets is low, at about 21% compared to 26% for stand-alone Frontier and digital subscriber line (DSL) availability is substantially lower at 60%, which could bolster growth prospects for data services in the intermediate term as Frontier invests in these markets. Still, Standard & Poor's expects the integration of the Verizon properties will be challenging given the size of the transaction. Additionally, while above average line losses of over 10% and lower DSL penetration provides opportunities for Frontier, they also entail the risk of further customer losses during an extended transition period.

Pro forma debt to EBITDA is moderate at about 3.0x, and significantly lower the 4.6x for Frontier on a stand-alone basis as of June 30, 2009, although we are concerned that execution missteps or deteriorating operating trends could result in higher leverage in the intermediate term. As part of the transaction, Frontier will need to raise about $3.2 billion of new debt. The pro forma EBITDA margin is about 48%, somewhat lower than stand-alone Frontier's 54% margin as of June 30, 2009, although still healthy relative to the industry. However, margins could decline in the near term because of line losses. Potential operating synergies are meaningful at about $500 million, or 21% of cash operating expenses, but achieving this will require solid execution during the integration and may be impeded by higher access-line losses or a more competitive industry environment. Frontier's ability to continue to operate under the legacy systems, if it chooses to, mitigates concerns about system switchovers from Verizon.

Liquidity

Frontier's current liquidity is adequate, consisting of roughly $454 million in cash and $250 million from an undrawn unsecured revolving bank loan as of June 30, 2009. The company generated about $144 million in net free cash flow in during the last 12 months, which should remain stable over the next year because of lower levels of capital spending, despite the company's significant dividend payout, which represents about 64% of free operating cash flow through the first six months of 2009.

We expect the company to have moderate headroom over the next year relative to the bank facility's maximum net debt to EBITDA covenant, which is 4.5x through the term of the agreement. Frontier amended the $200 million term loan with the Rural Telephone Finance Cooperative (RTFC) increasing the net debt to EBITDA covenant to 4.5x from 4.0x until maturity, which should also provide it with moderate cushion over the next year. Leverage under both the revolver and the RTFC term loan is calculated after subtracting cash in excess of $50 million from debt. Debt maturities as of the June 2009 quarter are manageable, including about $866 billion due in 2011.

Outlook

The outlook is stable. Despite the expectation for continued access-line erosion in both the legacy Verizon markets as well as the existing customer base because of increased cable telephony competition and wireless substitution, the company's moderate pro forma leverage, high margins, and net free cash flow generation support the outlook. Still, we could revise the outlook to negative if line losses accelerate from current levels, resulting in materially lower EBITDA. Although unlikely in the near-term, we could revise the outlook to positive if operating trends stabilize, including the continued improvement of line losses, and the company maintains adjusted pro forma leverage below 3x. This would likely entail the successful integration of the Verizon properties and execution of its enhanced marketing plans to increase DSL penetration and stem churn.

Related Research

"Key Credit Factors: Business And Financial Risks In The Global Telecommunication, Cable, And Satellite Broadcast Industry," published Jan. 27, 2009.

Ratings List

Ratings Affirmed

Frontier Communications Corp.	
Corporate Credit Rating	BB/Stable/--

New Rating

Frontier Communications Corp.	
Senior Unsecured	
US$450 mil sr nts due 2018	BB
Recovery Rating	3

Ratings Affirmed

Frontier Communications Corp.	
Senior Unsecured	BB
Recovery Rating	3

Complete ratings information is available to RatingsDirect subscribers at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com; select your preferred country or region, then Ratings in the left navigation bar, followed by Find a Rating.

Moody's Benchmark Ratios for Global Telecommunications Industry

Weight	Financial Metrics	Aaa	Aa	A	Baa	Ba	B	Caa
6%	Earnings Before Interest Taxes Depreciation and Amortization (EBITDA) Margin	> 50%	> 45%-50%	> 40%-45%	> 30%-40%	> 25%-30%	≥ 20%-25%	< 20%
7%	Debt / EBITDA	≤ 0.5x	> 0.5x-1.0x	> 1.0x-2.0x	> 2.0x-3.0x	> 3.0x-4.0x	> 4.0x-6.5x	> 6.5x
7%	Free Cash Flow (FCF) / Debt	> 25%	> 20%-25%	> 15%-20%	> 10%-15%	> 6%-10%	2%-6%	< 2%
10%	Retained Cash Flow (RCF) / Debt	> 60%	> 45%-60%	> 35%-45%	> 25%-35%	> 15%-25%	5%-15%	< 5%
8%	(Funds from Operations (FFO) + Gross Interest Expense) / Gross Interest Expense	> 12x	> 9x-12x	>7x-9x	>5x-7x	>3x-5x	2x-3x	< 2x
8%	(EBITDA - Capex) / Gross Interest Expense	> 8.0x	> 6.5x-8.0x	> 5.0x - 6.5x	> 3.5x - 5.0x	> 2.0x-3.5x	1.0x-2.0x	< 1x

Source: Moody's Global Corporate Finance, "Global Telecommunications Industry," December 2007.