COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

2005 AUG 12 P 3: 12
DOCUMENT CONTROL

STAFF REPORT

APPLICATION
OF

Verizon Communications Inc. and MCI, Inc.-For approval of Agreement and Plan of Merger resulting in the indirect transfer of control of MCImetro Access Transmission Services of Virginia, Inc., to Verizon Communications Inc.

CASE NO. PUC-2005-00051

PUBLIC VERSION

AUGUST 12, 2005

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EXECUTIVE SUMMARY

On April 11, 2005, Verizon Communications Inc. (Verizon") and MCI, Inc. ("MCI") (collectively, "Petitioners") filed a joint petition ("Petition") requesting approval pursuant to § 56-88.1 of the Code of Virginia of a merger between MCI and Verizon. Verizon wholly owns Verizon Virginia Inc. (Verizon VA") and Verizon South Inc. ("Verizon South"), the two largest incumbent local exchange carriers ("ILECs") in Virginia. MCI is the parent of MCImetro Access Transmission Services of Virginia, Inc. ("MCImetro"). MCImetro provides facilities based intrastate interexchange service and competitive local exchange service in Virginia

The Staff is not convinced that the Petitioners have met their burden of proof for the Commission to be satisfied, pursuant to Virginia Code § 56-90, that adequate service to the public at just and reasonable rates will not be impaired or jeopardized in Virginia by this merger between Verizon and MCI. The Petition provides little, if any, Virginia-specific information or economic studies on which the Commission can make such a determination.

Therefore, the Commission should consider two alternative approaches. First, the Commission could disapprove or deny the Petition without prejudice for the Petitioners to refile with additional and sufficient Virginia-specific information. In the alternative, the Commission could approve the Petition, subject to appropriate conditions that ensure adequate service to the public at just and reasonable rates will not be impaired or jeopardized. Exhibit 7 to this Report identifies the other parties' proposed conditions. The Staff's proposed conditions discussed in this Report are as follows:

- Require Verizon VA and Verizon South to file notice with the Commission of their affiliate agreements with MCImetro having an annual value in excess of $250,000 between either Verizon VA or Verizon South and MCImetro for two years.

- Require Verizon's affiliates providing intrastate interLATA long distance service in Virginia to submit revenue monitoring information to the Staff consistent with that required by IXC Rules.

- Require Verizon VA and Verizon South to respond to and resolve when possible, Commission complaints within 10 business days.

- Require Verizon VA, Verizon South and MCImetro to offer and purchase UNEs and/or interconnection arrangements through interconnection agreements. This includes interconnection agreements filed with the Commission pursuant to § 252 of the Telecommunications Act of 1996. In addition, the companies should be required to file other commercial interconnection agreements between the companies (outside § 251 obligations) with the Commission.

- Require Verizon VA and Verizon South to file to reclassify ATM and Frame Relay services as Other Local Exchange Telephone Services ("OLETS") under their Alternative Regulation Plan ("ARP").

- Require Verizon VA and Verizon South to modify their high capacity unbundled network element ("UNE") impairment wire center analysis (and corresponding availability) required by the Federal Communications Commission ("FCC") in its Triennial Review Remand Order to reflect MCI as a nonaffiliated fiber-based collocator in Virginia wire centers.

- Require the Petitioners to track the merger cost savings for Verizon VA, Verizon South, and MCImetro for a minimum of three years.

- Deny or defer approval on the proposed merger subject to the FCC and Department of Justice ("DOJ") reviews to allow evaluating the potential impact of any of their merger conditions on Virginia.

- Require Petitioners to file a report of action with the Commission within 30 days of consummation of the merger.

PART A – DIVISION OF PUBLIC UTILITY ACCOUNTING

Introduction

On April 11, 2005, Verizon Communications Inc. ("Verizon") and MCI, Inc. ("MCI"), the parent company of MCImetro Access Transmission Services of Virginia, Inc. ("MCImetro"), ("Petitioners")[1] filed a joint petition ("Petition") with the State Corporation Commission ("Commission") requesting approval, pursuant to § 56-88.1 ("Utility Transfers Act") of the Code of Virginia (" Va. Code") for a transaction that will result in indirect control of MCImetro being transferred to Verizon, in accordance with the Agreement and Plan of Merger dated February 14, 2005 ("Agreement"). The Agreement was amended March 29, 2005 ("March 29 Amendment"), changing certain terms and conditions of the Agreement, primarily related to merger consideration. This Petition was docketed as Case No. PUC-2005-00051.

The Petitioners represent that the proposed merger, which will result in the transfer of ultimate ownership and control of MCImetro from MCI to Verizon, will not impair or jeopardize the provision of adequate service to the public at just and reasonable rates, will advance the provision of a full array of competitively-priced, facilities-based, high quality services and products in a dynamic communications market, benefit the large enterprise, government and broadband market segments, and will allow consumers and small businesses to benefit from the enhanced deployment of wireline and wireless broadband services. The Petitioners also represent that the proposed transaction is a

[1] Although MCImetro was not listed as a Petitioner in the original application, the regulated entity is typically required to be included as a Petitioner in applications filed pursuant to Chapter 5 of Title 56 of the Code of Virginia, and the necessary verified signatures as required by the statute are required of the regulated company. Counsel for MCImetro informally was advised of this requirement and the necessary verifications were filed on April 20, 2005. Therefore, MCImetro also is considered a Petitioner.

response to current communications technology and industry development trends where the industry is evolving toward convergence and consolidation.

Background

Verizon is a Delaware corporation headquartered in New York, New York. Verizon, through its operating subsidiaries, provides telecommunications services, including switched residential and business services, local private line, voice and data services and Centrex services, on a regulated and unregulated basis in 29 states, Puerto Rico and the District of Columbia, serving 53 million access lines to consumers, small and enterprise businesses, and to other telecommunications carriers. Although Verizon is not a regulated telephone company, Verizon's local telephone subsidiaries are subject to public utility regulation. Verizon wholly owns two incumbent local exchange carriers ("ILECs") that provide interexchange and local exchange telecommunications services in Virginia, Verizon Virginia Inc. ("Verizon VA") and Verizon South Inc. ("Verizon South").

MCI is a Delaware corporation with its headquarters in Ashburn, Virginia. MCI's subsidiaries primarily serve large enterprise customers as well as 75 federal government agencies with communications services, including a comprehensive portfolio of local-to-global business data, Internet and voice services, including IP network technology, Virtual Private Networking, SONET private line, frame relay, ATM, and a full range of dedicated, dial and value-added Internet services. Although MCI is not a regulated telephone company, some of MCI's subsidiaries, including wholly owned MCImetro, a competitive local exchange carrier ("CLEC") and interexchange carrier ("IXC") in Virginia, are subject to public utility regulation in the jurisdictions in which they operate.

MCImetro, along with other MCI telecommunications services subsidiaries, provides customer services, including interstate long distance services, intrastate toll services, competitive local exchange services, and other telecommunications services. MCImetro is a Virginia public utility corporation providing local exchange and interexchange telecommunications services in Virginia pursuant to certificates of public convenience and necessity ("certificates") Nos. T-360 and TT-22B, respectively.

The Planned Merger

Pursuant to the Agreement and March 29 Amendment, MCI will merge with and into ELI Acquisition, LLC, a Delaware limited liability company, which is wholly owned by Verizon and was created solely to facilitate the transaction. Upon completion of the merger, ELI Acquisition, LLC, will be the surviving company, and Verizon will be the parent corporation and will rename ELI Acquisition, LLC, to "MCI, LLC."

On May 6, 2005, the Petitioners filed an Amendment of Pleading that included their May 1, 2005, second amendment ("May 1 Amendment") to the Agreement.[2] According to the Amendment of Pleading, the May 1 Amendment increases the financial consideration payable in the proposed transaction by modifying Section 1.8(a) of the Agreement to give MCI shareholders the right to receive a total of $26.00 (rather than the $23.10 contemplated by the March 29 Amendment) in cash and Verizon stock for each share of MCI stock they tender.

Under amended Section 1.8(a), MCI's shareholders will receive: (i) Verizon common stock equal to the greater of 0.5743 shares or the quotient obtained by dividing $20.40 by the Average Parent Stock Price (as defined in the Agreement); and (ii) a

[2] The Commission issued its Order Approving Amendment on May 20, 2005, approving the May 1 Amendment.

special dividend in the amount of $5.60 per share, less the per share amount of any dividends declared by MCI between February 14, 2005, and the consummation of the merger transaction. These modifications to Section 1.8(a) of the Agreement guarantee MCI shareholders a total value of $26.00 — $5.60 in cash promptly upon their approval of the transaction, plus cash and Verizon stock worth $20.40 — for each share of MCI stock they tender pursuant to the amended Agreement.

In addition to revising the financial terms of the proposed transaction as described above, the May 1 Amendment: (i) preserves Verizon's discretion to meet its compensation obligations by paying MCI shareholders additional cash instead of issuing additional shares over the 0.5743 exchange ratio set forth in Section 1.8(a) and (ii) obligates Verizon and its subsidiaries to vote any shares of MCI Common Stock they own in favor of adoption of the Agreement and approval of the merger so long as such adoption and approval is recommended by MCI's Board of Directors at the time of the vote. Finally, the May 1 Amendment revises the Agreement's definition of Excluded Shares to encompass stock held "in trust" or "for the benefit of" the Parties or their subsidiaries and substitutes May 1, 2005, for the Agreement's existing dates for certain financial and other disclosures.

The Petitioners represent that the May 1 Amendment does not affect the structure of the proposed acquisition and that it does not affect the analysis of whether the transaction meets the statutory standard under the Utility Transfers Act. The Petitioners further represent that the transaction under the terms of the May 1 Amendment neither impairs nor jeopardizes adequate service to the public at just and reasonable rates.

The Petitioners state that the transaction will not change the Commission's regulatory authority over Verizon VA, Verizon South, MCImetro, or other certificated affiliates. The Agreement does not call for any merger of assets, operations, lines, plants, franchises, or permits belonging to MCImetro with assets, operations, lines, plants, franchises, or permits of any Verizon entity. In addition, the Agreement does not call for any change in the rates, terms or conditions for the provision of any communications services provided in Virginia. To the extent that any such changes might be made at a later date, they will be subject to applicable regulatory approvals.

The Commission issued its Order for Notice and Comment on May 5, 2005. NTELOS Network Inc. and R&B Network Inc. filed comments on June 17, 2005. On July 18, 2005, Qwest Communications Corporation of Virginia filed comments and requested a hearing. Comments were also filed by Cavalier Telephone, LLC; Cox Virginia Telcom, Inc.; and Division of Consumer Counsel, Office of the Attorney General. On July 19, 2005, XO Communications Services, Inc., and DIECA Communications, Inc., d/b/a Covad Communications Company jointly filed comments and requested a hearing. The Commission issued its Order Scheduling Hearing on July 5, 2005, in which a public hearing was scheduled beginning September 1, 2005. The comments filed will be discussed in detail later in this Staff Report.

Discussion

The Petitioners state that the proposed transaction will benefit directly the large enterprise, government, and broadband market segments. The Petitioners represent that the post-transaction Verizon will be able to carry traffic over MCI's Internet backbone. According to the Petition, Verizon will also be able to utilize MCI's Internet Service

Provider connectivity services, thus, enhancing Verizon's capabilities in a market segment (large enterprise customers) in which it currently is a small provider.

The Petitioners further state that the proposed transaction is a rational business decision for MCI in light of its deteriorating mass market business and its lack of a wireless product set. It is further stated that competition has substantially eroded MCI's wireline consumer business and that MCI has concluded, separate from this transaction, that its consumer business is in continuing and irreversible decline. It is also stated that MCI has refocused its strategy accordingly and is managing its declining customer base.

After the proposed transaction is completed, MCI's regulated subsidiaries in Virginia will remain subsidiaries of MCI, and the certificates of public convenience and necessity will continue to be held by the respective entities. MCImetro will become a second-tier subsidiary of Verizon. The Petitioners state that, to the extent any reorganization might be made at a later date, it will be in the normal course of business and subject to applicable regulatory approvals.

The Petitioners state in the Petition that, after the acquisition, consumers will continue to have a choice of competitive communications services, including wireline competitors, cable telephony providers, wireless service providers, Internet and broadband providers, and Voice over Internet Protocol ("VoIP") providers. It is further stated that small business customers will continue to be served by a host of providers to serve this segment of the business market. The Petitioners represent that this competition, which will in no way be affected by the proposed transaction, is further proof that adequate service at just and reasonable rates will not be jeopardized.

As stated in the Petition, while it is anticipated that the proposed transaction will lead to some reduction in the number of employees in duplicative jobs, post-transaction planning has not yet begun, and there has not been any determination of the specific jobs that may be eliminated once the proposed transaction has been completed. The Petitioners state that efforts will be made to eliminate duplicative jobs through attrition and retirement.

Once the proposed transaction is consummated, Verizon VA, Verizon South, and other Verizon affiliates will become affiliates of MCI and its subsidiaries, including MCImetro. Therefore, any transactions between Verizon VA or Verizon South and MCImetro will be subject to Chapter 4 of Title 56 of the Code of Virginia (the "Affiliates Act"). Currently, Verizon VA and Verizon South have an exemption from the filing and prior approval requirements of the Affiliates Act under which the two companies submit an Annual Report of Affiliate Transactions ("ARAT") with the Commission's Director of Public Utility Accounting,[3] and no filing and prior approval for such affiliate transactions is required. Information to be included in such ARAT includes the identification of all transactions entered into with any affiliates during the preceding calendar year. MCImetro, along with other CLECs in Virginia, has not been brought under the Affiliates Act by the Commission.

The fact that Verizon VA and Verizon South will now become affiliates of MCImetro does raise a concern that the possibility will exist for transactions between affiliates in which Verizon VA or Verizon South may give preferential treatment to MCImetro in pricing or other considerations. Such preferential treatment regarding

[3] Such exemptions were granted by the Commission in its Order Granting Exemptions dated April 18, 2001, in Case No. PUA-2001-00007.

affiliate transactions could have an adverse impact on other CLECs and, therefore, customers of such companies.[4]

In Case No. PUA-1996-00044, in Final Order dated March 28, 1997, in which Bell Atlantic-Virginia, Inc., was granted exemption from the filing and prior approval requirements of the Affiliates Act, Bell Atlantic-Virginia, Inc., was required to file, within 60 days of entering into any new affiliated interest contract having an annual value in excess of $250,000 or an amendment to an existing contract in excess of $250,000, a non-proprietary notice containing a brief description of the contract or amendment, the entities involved, and the estimated annual revenues or expenses related to the contract or amendment. This requirement was for a two-year period.

Staff believes that Verizon VA and Verizon South could be required to file similar non-proprietary notices for two years as a condition on any approval in this case. This would allow CLECs the opportunity to raise issues related to such affiliate agreements, and it would provide the Staff a method of monitoring transactions between Verizon VA and Verizon South and MCImetro to ensure that transactions are conducted in such a way that the merger will not have an adverse impact on the provision of adequate service to the public at just and reasonable rates and that the affiliate transactions are in the public interest. This also will facilitate the CLECs' ability to ensure that transactions between Verizon VA and Verizon South and MCImetro are conducted in such a way as to not favor MCImetro over other CLECs at such CLECs' and their customers' expense and that competition in Virginia will not be adversely impacted by the transactions.

[4] Part C of the Staff Report addresses further concerns with the proposed merger.

As discussed further in this Report, Staff is not convinced that competition will not be diminished as a result of the proposed merger and that rates and service will not, therefore, be adversely affected. The financial aspects of the proposed transaction as well as service quality issues and merger costs and savings related to the proposed transaction also will be discussed later in the Staff Report, where specific concerns related to those areas will be discussed.

Conclusion

If this Petition is approved, one of Verizon VA's and Verizon South's major competitors will become part of Verizon and will no longer compete independently with Verizon VA and Verizon South. In fact, the proposed acquisition by Verizon of MCI will result in the combination of the Commonwealth's two of the largest telecommunications companies. With the elimination of a major competitor with Verizon VA and Verizon South in Virginia such as MCImetro, it is difficult to determine that such reduction in competition in Virginia will not result in adequate service to the public at just and reasonable rates being jeopardized or impaired.

Staff is not convinced that the Petitioners have met the burden of proving that the proposed merger resulting in the indirect transfer of control of MCImetro to Verizon has met the standard of the Utility Transfers Act. To ensure that the statutory standard is met, Staff believes that it would be necessary to impose certain conditions on any approval of the proposed merger. The Staff's specific conditions/concerns are identified in the Executive Summary.

PART B

PART B – DIVISION OF ECONOMICS AND FINANCE

Financial Issues

This portion of the Staff Report addresses some of the financial aspects of the proposed merger between Verizon and MCI. More specifically this section addresses potential financial impacts of the proposed merger on Virginia jurisdictional operations. From a Virginia regulatory perspective, one of the most critical financial aspects of any proposed merger is the potential impact it could have on the cost of and access to capital for jurisdictional operations. Merger related increases in business, operating, or financial risk could erode access to or increase the cost of capital necessary to support adequate and affordable service by Verizon Virginia and Verizon South in accordance with their public service obligation. By the same token, merger related decreases in business, operating, or financial risk could enhance access or reduce the cost of capital.

Under the old cost of service form of regulation, the threat to just and reasonable rates from increased capital costs as a consequence of a merger could be mitigated through the Commission's authority to determine an appropriate cost of capital for setting rates. In addition, any merger related savings on common cost items could be allocated so that all jurisdictional customers could be assured of sharing in any savings benefits. However, such direct measures are no longer available to the Commission under Verizon's Alternative Regulatory Plan ("ARP") of price ceiling regulation. Under the ARP, the level of protection afforded against merger related increases to the cost of capital is limited to 100% of increases in the Gross Domestic Product Price Index ("GDPPI") up to a maximum of 10% per year. Moreover, the ARP limits the ability to track, allocate, and share common cost savings from a merger among all customers versus targeted customers classes or customer services.

Bond Ratings

Bond ratings provide one relative measure of a company's total risk. From a financial investment perspective, the total risk of a company is most easily defined as the variability of earnings. Total risk can be divided into business risk and financial risk. Financial risk has to do with earnings volatility produced by the amount of debt, also called leverage, used to support operations. Higher amounts of debt financing produce higher earnings volatility and hence higher risk. The use of debt magnifies the impact of gains as well as declines in operating income on earnings. Business risk involves all of the remaining factors in a firms operation that could potentially impact its earnings (e.g., product elasticity, economic conditions, cost of material, the proportion of fixed costs to variable costs, substitute products and services, etc.). Based on the bond ratings of Verizon, MCI and their respective subsidiaries, MCI and its subsidiaries operate with a higher risk profile than Verizon and its subsidiaries.

Presently, Verizon and most of its subsidiaries have investment grade bond ratings in the single-A range. On May 20, 2005, Moody's downgraded many of Verizon's ILEC subsidiaries from the double-A ratings level to single-A due to the financial stress expected from the Verizon's plans to build fiber to the premises (FTTP) throughout much of its system. MCI and its subsidiaries, on the other hand have below investment grade debt ratings in the single-B range. However, rating agencies have indicated that MCI's ratings stand to be upgraded pending the proposed merger. The extent of such an upgrade will depend on whether Verizon will guarantee MCI's debt.

Conversely, ratings for Verizon and most of its subsidiaries have a negative ratings outlook due to prospective merger with higher-risk MCI. Considering Verizon's size and financial strength, along with MCI's cash position, analysts reports reviewed by Staff indicated that ratings for Verizon and its subsidiaries were not expected to fall below one notch (e.g., Moody's rating from A1 to A2), if at all. In the present market, the basis point difference between single-A and triple-B is averaging around 40 basis points. Based on this, Staff estimates that a one notch downgrade in debt ratings for Verizon and its subsidiaries to increase borrowing cost by about 10 basis points.

A shift of such magnitude is unlikely to have a devastating impact on access to capital by Verizon or its subsidiaries. However, it could erode some of their capacity to put more resources for use outside of interest payments. For each $10,000,000 of debt borrowed, 10 basis points equates to $10,000.

Potential Merger Impact on Business Strategy

Verizon's current business strategy is not to rely solely on providing traditional telephone services. The core local telephone service business is only the key to opening the door to much greater revenue streams from a portfolio of other bundled products and services from one source (local and long distance, wireless, high speed Internet access, calling features, TV, movies, etc.). That capability will be expanded and enhanced through Verizon's FTTP initiative and its acquisition of MCI's Internet backbone facilities. In addition to expanding Verizon's product offering capacity, FTTP will also add a measure of protection from competition because ILEC's are not required to unbundle services provided over fiber.

While FTTP is an integral component of Verizon's business strategy, it is an expensive proposition that will require significant funding over an extended period. A July 13, 2005 article by Forbes.com stated that "Verizon recently indicated it expects its FTTP build to pass 60% of its residential homes by 2010, or approximately 18 million homes,..."[1] However, Verizon intends to fund its FTTP build-out with a minimum of debt. Following Moody's previously noted downgrade of debt ratings for Verizon operating companies on May 20, 2005, Verizon issued a statement that the downgrades do "not reflect Verizon's overall business, including Verizon Wireless, but instead is limited to the operations of individual wireline companies—where we do not have plans to issue new public debt."[2]

To accomplish its FTTP initiative, funding will need to come from a variety of sources other than debt. In reviewing analyst reports provided in response to staff interrogatories (Exhibit 1), one report indicated that Verizon management projected the proposed merger to produce annual savings of $1 billon after the third year (Exhibit 2). Such savings could provide some of the funding needed for the FTTP initiative.[3] However, much of the funding for FTTP is planned to come from the sale of non-core rural wireline properties. An analyst report from Merrill Lynch (Exhibit 3), dated February 16, 2005, stated that:

> Given that the strategy of "repositioning" access lines is to harvest capital from non-core operations to finance the FTTP strategy without leveraging up the balance sheet of the strategic operating companies, we continue to

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[1] "ADC Telecom Boosted By Verizon FTTP Project", July 13, 2005, www.forbes.com/technology.enterprisetech/2005/07/13/adc-telecom-verizon-0713markets06.html.

[2] "Verizon Statement on Moody's Acton", May 20, 2005, http://investor.verizon.com/news/view.aspx?NewsID=633.

[3] "Acquiring MCI...Will Spin Occur?", Telecom Update, High Grade Research, Bear Stearns, February 17, 2005, Bear Stearns & Co. Inc. 383 Madison Avenue, New York, NY 10179.

> believe that the operating companies that reside within the Boston-Washington D.C. corridor will remain integral to Verizon…[4]

The same report goes on to discuss that the proposed merger may slow down "…Verizon's stated goal of divesting 10 – 12 million principally rural access lines." The rationale given for that opinion was that:

> It may prove awkward to simultaneously ask state regulators to approve the acquisition of MCI's CLEC operations to compete in the urban enterprise market while asking the same regulators to bless an exit from *their rural jurisdictions.*[5]

Verizon's strategy to hold off on procuring external financing for its FTTP initiative could help to protect it from further bond rating downgrades until cash flows from expected merger savings and bundled services to FTTP customers are sufficient to pay for debt financing. Verizon's strategy also reserves its borrowing capacity for future needs that may become more critical if projected increases in internally generated funds do not materialize to the extent expected from merger savings, access line sales, and enhanced revenues from FTTP, wireless, and enterprise operations. With this strategy, however, Verizon also risks forgoing favorable interest rates in the current capital market to potentially be faced with less favorable interest rates for permanent financing later.

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[4] "Verizon Communications Implications for Bondholders of MCI Acquisition – State Regulators Gain Negotiating Leverage" Merrill Lynch Fixed Income, February 16, 2005, Merrill Lynch Global Securities Research & Economics Group.

[5] Ibid.

The previously noted analyst report from Merrill Lynch discusses a potential imbalance in credit profiles if the FTTP assets are owned and depreciated as assets of the local operating companies but other revenues enabled by FTTP (long distance, DSL, video and TV) are booked at the holding company level. It goes on to note that such imbalances could be addressed over the longer-term through debt guarantees between the operating companies, Verizon Network Funding Corporation, and their parent holding company, Verizon. Such imbalances could raise the cost of financing by the ILECs for further FTTP build-out as well as ordinary maintenance and service for traditional telephone service over copper wire.

While FTTP holds great promise of enhanced income from expanded products and services, it also faces increased competition from cable companies offering similar products and services. Similarly, prospects for increasing income from Verizon's merger driven foray into the enterprise market are subject to competition as well. Consequently, Verizon's goal to avoid the issuance of debt, pressure to maintain cash flow and earnings to support credit ratings, and investor expectations to maintain dividend payments may prompt it to maximize earnings from less competitive telephone services provided by the ILECs to support and sustain non-jurisdictional operations if merger-enabled ventures do not perform as planned or projected merger savings do not materialize as expected. Efforts to increase earnings from less competitive telephone services could be a product of both increased revenues from maximum allowable rate increases under the ARP and reduced expenses. Reduced expenses, whether through labor or material, have the potential to erode service quality.

The Staff is unable to determine whether these potential financial concerns could impair or jeopardize adequate service at just and reasonable rates. However, we believe that the proposed merger could adversely impact the cost and availability of capital to some extent for Verizon Virginia's and Verizon South's jurisdictional operations.

Measuring Competition

This section evaluates the Verizon/MCI proposed merger with respect to the actual and/or potential effect on competitive activity in Virginia, in both the long distance and local exchange markets. As discussed in Part C of this Report, actual or potential anticompetitive effects of a merger could negatively affect just and reasonable rates as prescribed in Va. Code § 56-90.

Long Distance Market

The Staff has monitored the Virginia intrastate, interLATA long distance market since 1984, when the Commission relaxed its regulation over IXCs. Since it was sanctioned in Virginia, intraLATA long distance competition has been included in the long distance monitoring.[6] During the early stages of long distance competition the Staff calculated a Herfindahl Hershman Index ("HHI")[7] as one measure of the progress of competition in the long distance market in Virginia. However, for the last few years the HHI has not been calculated because the Staff believed that the market was sufficiently competitive in Virginia.

[6] Each certificated carrier must provide total Virginia intrastate revenue each year for the annual period.

[7] The Herfindahl Hershman Index, or HHI, is an index used to measure market concentration. The index is calculated by summing the squared market shares for all market participants. The level of the index, between 0, perfect competition, and 10,000, complete monopoly, is then used as one measure of the level of concentration in a market. It is the trend of the index over time that is the most important.

MCImetro is the largest facilities based IXC[8] in Virginia, based upon revenues reported by certificated carriers in Virginia. The Staff requested Verizon's Virginia intrastate interLATA long distance revenue[9] in order to calculate an HHI for purposes of this case. Verizon responded that it was unable to provide its full interLATA revenue for Virginia, saying that it does not break out its interLATA long distance revenue from its bundled service offerings.[10]

Through its affiliates, Verizon is likely one of the largest long distance carriers in Virginia. In response to Staff Interrogatory No. 6, First Set, Exhibit 5, Verizon provided an estimate that its long distance market share in Virginia was [redacted]%, as of December 31, 2004. A merger of the two possibly largest long distance carriers in Virginia would represent a substantial reduction to competitive long distance activity in Virginia.

Taking into consideration the risk to competition in the long distance market in Virginia, the Staff believes that Verizon should be required to report, going forward, all Virginia intrastate interLATA long distance revenue from its subsidiaries providing long distance in Virginia, so that the Staff can more accurately monitor and report to the Commission on competitive activity in Virginia.

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[8] 2004 revenue was reported by MCI Worldcom, also a subsidiary of MCI, whose certificate has since been cancelled. MCImetro now provides all local and long distance service for MCI in Virginia.

[9] Since Verizon provides its interLATA service through affiliates that are not certificated in Virginia, Staff does not receive this information as a part of the Commission's ongoing reporting (monitoring) requirements.

[10] Response to Staff Interrogatory #9, First Set, June 13, 2005, Exhibit 4.

As the Staff has stated many times in the past, the HHI is one measure of competition which must be observed in combination with other market factors, such as the level of rates or changes in rates. It is the trend of the HHI over time that provides the most important information regarding competitive activity. While the Staff is unable to calculate an HHI for the long distance market in Virginia due to lack of data, it is clear that a merger of the two possibly largest long distance carriers in Virginia will cause the HHI to increase dramatically.

If Verizon affiliates have almost [redacted]% of the Virginia long distance market, then the merged Verizon/MCI companies could bring an HHI of approximately 4150, an increase of 2312 over an estimated HHI with Verizon competing against MCI for long distance customers.[11] The U.S. Department of Justice ("DOJ"), Antitrust Division's "Antitrust Division Policy Guide to Merger Remedies" references a change of greater than 50 points[12] as a signal of potentially anti-competitive concerns and considers a market with a ratio above 1800 as highly concentrated.

Local Exchange Competition

The Staff has monitored the competitive local exchange market in Virginia since the inception of local competition in 1996. Previously, the Staff has not calculated an HHI for the local market in Virginia. While there are many active competitors in Virginia, most individual market shares, as a percent of total access lines in Virginia, are

[11] The HHI is sometimes presented and referenced without decimals, under which circumstances the HHI would fall between 0, perfect competition and 10,000, complete monopoly. In the past the Staff referenced the HHI using decimal places, for example .5000, for consistency we will refer to the HHI as do most, 5000.

[12] http://www.usdoj.gov/atr/public/guidelines/horiz_book/15.html.

quite small. An HHI is generally unaffected by the small market shares.[13] However, Virginia now has five carriers whose market shares are sufficiently large to have an effect on the HHI.

The Virginia local market, as reported to the Staff as of December 31, 2004, (including incumbent lines) reflects a combined entity, Verizon Virginia, Verizon South and MCImetro, with [redacted]% of access lines. All local carriers competing in Virginia, regardless of whether they are facilities based, UNE-P, UNE-Loop or resale, are dwarfed by Verizon. The next largest local carrier has [redacted]% of access lines in Virginia as of December 31, 2004.

Because of the potential effect of the Verizon/MCI merger on the Virginia competitive local exchange market, the Staff has calculated an HHI. Based upon this data, presented in summary on Exhibit 6, the HHI prior to the merger of Verizon and MCI would be 4442, after the merger the HHI would increase to 4750, an increase of 308.[14] This increase exceeds the 50 point increase DOJ characterizes as raising significant competitive concerns.

At this time there appears to be a trend of consolidation in the local and long distance markets nationwide. The telecommunications business is a very capital intensive venture and larger carriers may be more stable and better able to compete, due in part to a greater ability to raise capital. However, the merger of Verizon and MCI in Virginia has negative implications for consumers, both residential and business. Virginia

[13] The HHI is calculated by squaring each market share and then summing all squared market shares to determine the index.

[14] The HHI calculated for local competition does not include any data for wireless or VoIP services, both of which may be considered as alternative to services, both long distance and local, provisioned by MCI and Verizon.

loses an important independent competitor, MCI, leaving fewer choices in the short term for Virginia's consumers and the potential for higher prices due to lessened price competition.

The potential for anti-competitive effects of the proposed merger of Verizon and MCI in Virginia, as evidenced by the change in the HHI both for long distance and local exchange, places emphasis on the importance of conditions, as noted above and in other sections of the Staff's Report, on the merged entities to help insure fair competition going forward.

Part C - DIVISION OF COMMUNICATIONS

General

Prior to approval of any proposed acquisition or change in ownership and control of a telephone company, Va. Code § 56-90 requires that the Commission be satisfied that the change will not impair or jeopardize adequate service to the public at just and reasonable rates. This section of the Report identifies and assesses the appropriate service and rate standards the Commission should consider in its review of the merger of MCI and MCImetro[1] with Verizon.

In addition, the Office of General Counsel has filed a legal memorandum that addresses the applicability of the provisions of Va. Code § 56-235.5:1 to the Utilities Transfers Act (Chapter 5, Va. Code § 56-88 through § 56-91) approval process. This memorandum demonstrates that the public interest standard and this statute are applicable and, therefore, may be taken into consideration in evaluating the proposed merger in Virginia. The potential effects of the proposed merger on the goals of the Va. Code § 56-235.5:1 are discussed later in this Report.

As has been the position of the Division of Communications in previous mergers or changes of ownership or control,[2] a merger between two telecommunications companies must be evaluated in light of the Commission's method of regulation of the carriers involved (or their

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[1] MCImetro is the MCI entity that holds Virginia certification to provide competitive local exchange and interexchange telecommunications services. MCImetro holds Certificate No. T-360 to provide local exchange telecommunications services granted May 30, 1996, in Case No. PUC-1995-00083, and Certificate No. TT-22B to provide interexchange telecommunications services granted September 28, 1995, in Case No. PUC-1995-00072.

[2] See March 23, 1998, Staff Report in Petition of MCI Communications Corporation and WorldCom, Inc., Case No. PUC-1997-00052; September 24, 1999, Staff testimony in Joint Petition of Bell Atlantic Corporation and GTE Corporation, Case No. PUC-1999-00100; November 23, 1999, Staff Report in Joint Petition of AT&T Corp. and Mediaone Group, Inc., Case No. PUA-1999-00043; and May 31, 2002, Staff Report in AT&T Corp. and AT&T Comcast Corporation, Case No. PUA-2002-00012; May 13, 2005, Staff Report in Joint Petition of SBC Communications, Inc., AT&T Corp., AT&T Communications of Virginia, LLC, and TCG Virginia, Inc., Case No. PUC-2005-00035.

affiliates/subsidiaries) and give consideration to the markets in which they operate. The evaluation of a proposed merger should focus on the affected jurisdictional intrastate service and rates. Such an evaluation should not only include the impact on the companies (and their customers) involved in the merger but also should assess any impact on the Virginia telecommunications marketplace as a whole. In other words, such an evaluation is not limited to reviewing the impact on the entities whose ownership (or control) is being changed.

The proposed merger involves several critical elements that make its scrutiny particularly imperative. First, it involves the two largest ILECs in the Commonwealth, Verizon VA and Verizon South.[3] The service territories of these two ILECs account for over 90% of the total telephone access lines in Virginia. Second, MCImetro is presently the largest intrastate facilities-based IXC in the Commonwealth. Third, MCImetro is one of the largest CLECs in Virginia and competes exclusively in the service territories of Verizon VA and Verizon South.[4] Furthermore, both MCI and Verizon have additional subsidiaries that provide intrastate long distance services on a resale basis in Virginia. In fact, Verizon's affiliates[5] claim a significant

[3] In addition, Verizon has two CLEC subsidiaries, VIC-RMTS-DC, L.L.C. d/b/a Verizon Avenue and Verizon Select Services of Virginia Inc. certificated in Virginia. VIC-RMTS-DC, L.L.C. d/b/a Verizon Avenue holds Certificate No. T-386a to provide local exchange telecommunications services issued June 22, 2001, in Case No. PUC-2001-00025, and Verizon Select Services of Virginia Inc. holds Certificate No. T-614 to provide local exchange services, issued June 27, 2003, in Case No. PUC-2003-00039.

[4] MCImetro has a statewide local exchange certificate; however according to its tariff, it presently only offers service in selected Verizon VA and Verizon South exchanges.

[5] According to Petitioners' response to Staff Interrogatory No. 6, Bell Atlantic Communications, Inc. d/b/a Verizon Long Distance ("Verizon LD"), and NYNEX Long Distance Company d/b/a Verizon Enterprise Solutions ("Verizon ES") offer interLATA long distance services to consumers in Virginia. InterLATA long distance service to business customers is offered by Verizon Select Services Inc. ("VSSI").

portion of the Virginia consumer long distance market.[6] We also note that MCI[7] provides various services to the Commonwealth of Virginia under the COVANET contract.[8]

It is apparent that this proposed merger involves very significant players in the telecommunications industry in Virginia. This merger of Virginia heavyweights will have an industry altering impact on the Virginia telecommunications marketplace by eliminating MCImetro as a strong independent competitor in several different markets and, therefore, increasing the presence and position of Verizon (and its affiliates).

As the Petitioners point out,[9] the Staff believes the Commission's role in regulating the various companies in their markets can generally provide an implicit definition of "adequate service at just and reasonable rates" under Va. Code § 56-90. This definition would also vary, as the regulation and markets vary for different telecommunications carriers.

Regulation

IXCs providing intrastate long distance service on a facilities basis are certificated and regulated by the Commission pursuant to 20 VAC 5-411-10 et seq. of the Virginia Administrative Code ("IXC Rules"). The IXC Rules include Rule 30 E which allows an IXC to request that its rates be set competitively pursuant to Va. Code § 56-481.1. To date no carrier has been denied such pricing authority. Currently, Virginia has 121 certificated IXCs. The IXC Rules provide various safeguards for Virginia customers including requiring tariffs, advance notice to customers of any rate increases, and approval from the Commission before abandoning

[6] According to Petitioners' response to Staff Interrogatory No. 6, Verizon LD has [redacted] market share of the Virginia long distance marketplace.

[7] The COVANET contract is between the Commonwealth of Virginia and MCI WorldCom Communications Inc. We suspect that this MCI company name has subsequently changed.

[8] Verizon also provides services to the Commonwealth pursuant to contract.

[9] Petition, p 19.

or discontinuing service. In addition, intrastate long distance services are offered in Virginia by numerous resellers. The Commission determined in Case No. PUC-1983-00005[10] that it would not regulate WATS resellers.[11] Therefore, such resellers are not presently required to obtain operating certificates or otherwise comply with the IXC Rules.

New entrants to the local exchange market, CLECs, are specifically certificated and regulated by the Commission pursuant to 20 VAC 5-417-10 et seq. ("Local Rules") and 20 VAC 5-423-10 et seq. ("Discontinuance Rules") of the Virginia Administrative Code. There is no distinction between regulating CLECs utilizing either their own facilities or purchasing services from ILECs (or other carriers) on a wholesale or resale basis. Regulations applicable to all local exchange carriers may also apply. Each new CLEC entrant is required to show its financial, managerial, and technical ability before it can be granted authority to provide service. The Local Rules provide that CLECs must meet certain conditions for certification, including service quality standards, minimum service requirements, and price ceilings. As with the IXC Rules, both the Local Rules and Discontinuance Rules provide various consumer protections. Currently, Virginia has 180 certificated competitive local exchange carriers.[12]

ILECs are governed by various statutes and Commission regulations. In this instance, both Verizon VA and Verizon South are primarily regulated pursuant to an alternative regulatory plan ("ARP").[13] The ARP applies to both companies and was designed to meet the requirements

[10] Ex Parte: Investigation of the resale or sharing of intrastate Wide Area Telephone Service ("WATS"), Order dated June 7, 1983.

[11] Ibid p. 4

[12] Of this number, only 84 CLECs currently have tariffs on file with the Commission, which is required prior to offering services to the public.

[13] Verizon VA and Verizon South are regulated by an ARP approved by this Commission and other regulations applicable to all local exchange carriers. Verizon VA and Verizon South's ARP was last revised (and combined) on January 5, 2005, in Case No. PUC-2004-00092.

of Va. Code § 56-235.5. It includes provisions for classifying services into various categories based on their nature (i.e. basic, other, bundled, and competitive) and their applicable price change requirements. For example, services that are determined to be basic local exchange telephone services ("BLETS") are capped at a ceiling price and may only increase over the ceiling by an annual inflation factor. On the other hand, services that have been determined to be competitive are free from pricing restraints. However, the ARP includes other requirements that address such items as customer notice for price increases, competitive safeguards, individual case basis ("ICB") filings, and revenue neutral filings.

In addition, ILECs offer wholesale services to CLECs pursuant to provisions of the federal Telecommunications Act of 1996 ("Act") as well as state statutes and Commission regulations (20 VAC 5-419 et seq. and 20 VAC 5-429 et seq.). Such services include Unbundled Network Elements ("UNEs"), resale of tariffed service offerings, access services, and interconnection. These wholesale services are primarily provided to CLECs pursuant to negotiated and/or arbitrated interconnection agreements that are filed and approved by state commissions pursuant to § 252 of the Act.[14] CLECs use these services to provide local exchange services to their customers.

Therefore, the requirements set forth in the Commission's various rules, as well as other applicable regulations and statutes, generally establish the standards for determining adequate service to the public at just and reasonable rates, as required by Va. Code § 56-90. It is the Staff's position that this proposed merger would not alter neither the responsibility nor the necessity of the Virginia certificated subsidiaries of both Verizon and MCI to comply with or abide by the standards set forth in any of the rules described above or any other regulations of

[14] These are filed with the Commission pursuant to 20 VAC 5-419 et seq.

this Commission, including service quality rules (20 VAC-5-400-80 of the Virginia Administrative Code). However, such an obligation alone does not suggest that any merger need not be fully evaluated. A merger could result in a situation that prevents a participant from meeting such obligations. It is also possible that a merger could impact the dynamics of the marketplace significantly enough to impair or jeopardize adequate service at just and reasonable rates. This could require a change in applicable regulations and therefore, in effect, the standards used to evaluate a merger. That is not to say that we assume that to be the case with this merger; however, considering the significance of this merger, it is a concern.

Markets

Long Distance

In effect, the current definition of just and reasonable rates in the interexchange marketplace in Virginia is "market based" or "competitively determined," and no threshold for those rate levels has been determined or has been found to be necessary to date. Regarding adequate service, the Commission has never established specific service quality standards for IXCs. The market based approach applied to pricing has also applied to service standards. However, the IXC Rules provide potential sanctions for an IXC with excessive subscriber complaints, including suspending or revoking the carriers' certificate. Nevertheless, in the competitive interexchange market, consumers in Virginia may always choose service from one of the other carriers if they are dissatisfied with either the rates or services provided by a specific long distance carrier.

MCImetro provides long distance services to consumers in Virginia (residential and business), is subject to the IXC Rules. In addition, as previously mentioned, several affiliates of Verizon and MCI provide intrastate services on a resale basis, and therefore, are not certificated and not currently regulated under the IXC Rules.[15] Furthermore, Verizon VA and Verizon South provide intrastate intraLATA long distance service as a competitive offering pursuant to their ARP.[16] As demonstrated by the discussion in Part B of this Report, the proposed merger between Verizon and MCI will result in a considerably more concentrated long distance market in Virginia. Although this raises potential concerns, we do not believe that a significant increase in market share alone would necessarily result in prices for mass market (residential and small business) customers that are not just and reasonable (still competitively determined).

This merger (or even the SBC/AT&T merger[17]) may, in fact, potentially have a negative impact on intrastate long distance rates. However, we believe that there are other factors that are influencing the price a given long distance carrier may charge that provide for the sustainability of the current form of market based regulation. An important element is the increasing commoditizing of long distance service and the relative ease of entry into the market. Easy entry into the long distance market is highly dependent on the availability of facilities from other carriers (or ability to resell bulk services purchased from other carriers) and there have historically been a large number of carriers with excess capacity for lease. In addition, access to a long distance carrier's customers is typically controlled by the customers' local exchange carrier.[18] Furthermore, long distance carriers only have so much ability to raise rates as some

[15] In response to Staff interrogatory No 6, Verizon states that Verizon LD and other affiliates provide long distance service to customers in Virginia as a reseller. The Staff does not necessarily agree that such provision is resale.

[16] The regulatory treatment of these intraLATA long distance services is subject to the applicable regulations set forth in the IXC Rules.

[17] Merger of AT&T Corp., AT&T Communications of Virginia, LLC, (AT&T-VA") and TCG Virginia, Inc. with SBC Communications Inc., Case No. PUC-2005-00035 ("SBC/AT&T merger").

[18] In Virginia, the majority of customers obtain local service from the Verizon ILECs.

consumers increasingly may use alternative technologies for long distance calling, such as wireless.

However, there are additional factors that make this proposed merger of further concern in the competitive long distance market. In this instance, Verizon owns the two largest ILECs in Virginia. Long distance carriers pay access charges to these companies, Verizon VA and Verizon South, to originate and complete long distance calls for their customers. To the extent MCImetro (and other affiliates) and Verizon LD (and other affiliates) provide long distance services to Verizon VA and Verizon South's local exchange customers, they will have a cost advantage over their competitors since they are in effect only "imputing" access charges (not paying). To a great extent, this problem has been mitigated by the switched access charge reductions required by the Commission in Case No. PUC-2003-00091.[19] However, the Commission may need to address whether it is necessary to reduce Verizon VA's and Verizon South's switched access charges further (i.e. to cost) to mitigate any further unreasonable competitive advantage achieved by the this merger.

Another concern arises from the possible demise of MCImetro[20] (along with the already announced marketing withdrawal of AT&T-VA) from the consumer marketplace for both long distance and local exchange service. This could have an impact on rates offered by other long distance carriers (or CLECs) as MCImetro (and AT&T-VA) has often been a price leader or helped establish the de facto price ceiling for other IXCs. MCImetro's apparent decline in its local and interexchange services began prior to the announced merger. Therefore, it would not

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[19] Petition of AT&T Communications of Virginia, LLC for reduction in the intrastate carrier access rates of Verizon Virginia Inc. and Verizon South Inc. Final Order dated February, 9, 2005.

[20] The Petition (p. 17) claims that MCI recognizes that its consumer business is in a "continuing and irreversible decline." However, according to the Petitioners' response to Staff Interrogatory No.7, MCImetro has no immediate plans to discontinue offering consumer services to either existing or new customers in Virginia.

generally be seen as a direct result of the merger.[21] However, since Verizon affiliates are also in the consumer long distance business, it is possible that this merger would result in a much quicker demise of MCImetro as either an entity in the marketplace or particularly as a separate "real" choice in the long distance market.

The Commission has a long standing policy to allow the intrastate interexchange marketplace to be market driven. We support continuing this policy, absent sufficient evidence that a particular action or actions would result in the services no longer being provided to the public on a competitive basis, demonstrating a need to reregulate the market. This merger does raise concerns as discussed above. The dynamics and viability of the standalone interexchange marketplace is being influenced by other factors (i.e. bundled services and other technologies) so we see no reason to oppose the proposed merger on this basis. However, we suggest that the Commission monitor the situation to determine whether a change in regulation may be necessary (as discussed in Part B of the Report) and whether further switched access charge reductions are necessary.

Local Exchange Market

As mentioned earlier, MCImetro is a certificated CLEC and Verizon also has two certificated entities authorized to offer competitive local exchange services in Virginia. In this marketplace, the Commission has effectively determined that "just and reasonable" rates for local exchange service provided by CLECs may not exceed the rates charged by ILECs. In adopting this pricing standard, the Commission recognized both the continuance of market

[21] The Petitioners claim that MCI saw a 20% decline in consumer revenues between 2003 and 2004 (Petition, p. 11). However, the Petition does not mention how much of this loss was as a result of Verizon's entry into the long distance market.

and/or monopoly power of the ILECs and the need to encourage further competition in the local exchange marketplace.

However, a principal concern with this proposed merger is what impact it will have on the competitive local exchange marketplace and, potentially, on the rates of Verizon VA and Verizon South. The proposed merger would eliminate MCImetro as a significant independent player in the competitive local exchange marketplace. While the Petition states that MCImetro's mass market is deteriorating,[22] this does not fully mitigate our concerns as described in the long distance market discussion above. As discussed in Part B of this Report, the acquisition of MCImetro by Verizon would significantly increase concentration in the local exchange market.

There is no doubt that MCImetro has been active in challenging certain rates of the ILECs in the past. These challenges have been primarily focused on intrastate access charges and UNE rates. As with the probable loss of AT&T-VA (as a result of the SBC/AT&T merger) as an active CLEC in ILEC challenges, we fully anticipate MCImetro's role in such future cases will likely be eliminated as it will be affiliated with the two largest ILECs in Virginia. As mentioned in the Staff Report in Case No. PUC-2005-00035, we have relied on parties' opposing views and cost studies in evaluating certain ILEC rates and prices. Our jobs will become more difficult as a result of this merger, especially in light of the SBC/AT&T merger. As stated in the PUC-2005-00035 Staff Report, we are not suggesting this situation alone be used as justification for opposing this merger, but it does emphasize that the telecommunications competitive landscape in Virginia, with the continuation of mergers between the larger players in the market, is changing and that does not always mean such change is necessarily good for consumers, competitors, or the Commonwealth.

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[22] Petition, p. 3.

Furthermore, the proposed merger between Verizon and MCI identifies additional challenges because of the relationship between Verizon VA and Verizon South as the primary wholesale providers of services to MCImetro and other CLECs. For one, there is the potential for MCImetro, to the extent it remains in the market, to obtain preferential prices, terms and/or conditions from these wholesale suppliers. In addition, as discussed above, with the elimination of MCImetro as a strong opponent to Verizon in negotiations and subsequent UNE arbitration proceedings, it is possible that overall wholesale prices charged by Verizon VA and Verizon South to the CLECs may become higher in the future. The interested parties' comments in this case detail these concerns. For the most part, the parties' comments suggest that the merger should be denied; however, alternatively, the parties suggest a number of conditions for the Commission's consideration. Exhibit 7 identifies the conditions proposed by interested parties.[23] We are not commenting on all these proposed conditions; however, some could mitigate the potential anti-competitive aspects of this merger. This Report discusses some specific Staff concerns.

Service Quality

The Commission, pursuant to Va. Code § 56-90, "shall be satisfied that adequate service to the public...will not be impaired or jeopardized..." by the proposed merger of Verizon and MCI. We interpret this requirement to mean that existing service is presumed to be reasonably adequate (even if it is deficient in some areas) and that such service, following the merger, will not be diminished.

[23] Based on the Staff's review of the parties' comments. This list may not be totally complete as it is possible we missed or misunderstood various points.

Current Service Performance Analysis

In measuring the current level of service quality provided by Verizon VA, Verizon South, and MCImetro, we primarily looked at two measures -- service performance results and Commission complaints.

Verizon VA, Verizon South, and MCImetro, as providers of local exchange services, are subject to the Regulations Governing Service Standards for Local Exchange Companies pursuant to 20 VAC 5-400-80 et seq. A review of 2004 and the first two quarters of 2005 revealed a mixed performance record. MCImetro's[24] results for repeat reports for the first quarter of 2004 were unsatisfactory.[25] Verizon VA's results for network switching were unsatisfactory for the fourth quarter of 2004 as well as the second quarter of 2005. Business office access performance results have been generally unsatisfactory for Verizon VA and MCImetro.

Commission Complaints

Included in the aforementioned service standards is a measure that addresses Commission complaints. The threshold for satisfactory performance in this standard is less than one justified Commission complaint per-1000 access lines, per year. Verizon VA's, Verizon South's, and MCImetro's performances are all well within the Commission's complaint threshold standard for 2004 and, on an annualized basis, through the second quarter of 2005. With that said, complaints regarding directory listing errors and omissions have risen dramatically over the past several years. Accordingly, the Commission has ordered the Staff to conduct an investigation of Verizon VA's and Verizon South's directory listing problems (Case No. PUC-2005-00007).

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[24] MCImetro and MCI WorldCom filed performance results separately in 2004. The results for the repeat reports measurement was reported by MCI WorldCom.

[25] For the purpose of its analysis, the Staff used an average of monthly data to develop a quarterly result.

While that investigation is well underway, it has not yet concluded. As such, it would be premature for the Staff to comment on Verizon VA's and Verizon South's directory listing issues in the light of this proposed merger.

Of the long distance related complaints filed at the Commission, a relatively small share belonged to MCImetro and Verizon LD.[26] In 2004 there were a total of 1,030 complaints filed regarding the performance of long distance providers AT&T Communications of Virginia, LLC, Sprint Communications Company of Virginia, Inc., MCImetro, and Verizon LD. Of those, only 197, or 19 percent, were filed against MCImetro and Verizon LD combined. As the complaints were further sorted by type (interstate versus intrastate), only 42 of the 351 intrastate long distance related complaints, or 12 percent, were attributed by the Staff to MCImetro and Verizon LD. A review of first and second quarter 2005 complaints also yielded favorable results.

As was mentioned in the Staff Report in Verizon VA's and Verizon South's ARP proceeding,[27] we remain increasingly troubled about Verizon VA's and Verizon South's responsiveness to Commission complaints. For the first quarter of 2005, Verizon VA's and Verizon South's average resolution interval for justified Commission complaints exceeded 22 calendar days. Thirty-seven percent, or 115, of Verizon VA's and Verizon South's second quarter 2005 complaints went unresolved for over 30 days. For the second quarter, the response interval exceeded 31 days.[28] By way of comparison, MCImetro's average resolution interval for the same two periods was 17.1 and, a much more respectable, 9.8 days. Our expectation, as laid

[26] Verizon claims that Verizon LD is a long distance reseller and, as such, is not under the regulation of the Commission. However, the Staff has an arrangement directly with Verizon LD to handle customer complaints.

[27] Case No. PUC-2004-00092.

[28] For the purpose of this calculation, we excluded complaints with a response interval of 200 days or greater.

out in the *Operating Service Criteria for Virginia Telephone Utilities,*[29] is that companies reply to Commission complaints in ten calendar days.

Customers call the Commission when all other efforts have failed. For that reason, we expect company officials to handle Commission complaints in a timely, accurate, and complete manner. While MCImetro's response interval has at least been reasonably adequate, Verizon VA's and Verizon South's has not. Moreover, and unfortunately, years of Staff-initiated informal corrective action with Verizon has proven to be, by and large, futile. Significant short term improvements are made, only to be followed by a repeat of the poor performance.

Wholesale Service Quality

In this proposed merger, the impact on "adequate" service quality provided to CLECs by Verizon VA and Verizon South must also be considered. As noted earlier, many CLECs rely on Verizon VA and Verizon South for wholesale products in order to provision services to their customers in Virginia. Therefore, the service quality surrounding these wholesale services (as well as interconnection) has a substantial impact on the adequacy of the service provided by the CLECs and in effect, their ability to comply with any Commission retail service requirements.

Currently, Verizon VA and Verizon South have performance standards and remedy obligations to CLECs in accordance with various orders in two Commission cases. Case No. PUC-2001-00206 established Verizon VA's and Verizon South's wholesale "Carrier to Carrier Guidelines" ("VA Guidelines"). Case No. PUC-2001-00226 "Verizon Performance Assurance Plan" ("VA PAP") provides for payment credits for the Companies' failure to meet satisfactory performance standards. MCImetro, as a CLEC, is entitled to credits under the VA PAP. However if the merger is approved it will become an affiliate of Verizon VA and Verizon South.

[29] *Operating Service Criteria for Virginia Telephone Utilities,* Customer Complaint Handling and Reporting (Para. 8).

Therefore, it would be necessary to determine the appropriate status of MCImetro for the VA Guidelines and VA PAP (i.e. in CLEC results or in Verizon's results).

We have a few concerns with respect to service quality provided to Verizon VA's and Verizon South's wholesale customers. First, we must ensure that MCImetro does not receive preferential treatment over other CLECs, and that Verizon VA and Verizon South continue to support their wholesale operations with sufficient resources. Furthermore, the question of MCI's continued provision of wholesale services has been raised by several interested parties and may need to be considered further. The Petition does not address any of these issues. For the most part, we believe the VA Performance Standards, VA PAP and the Collaborative Committee currently provide sufficient mechanisms to maintain at least the present level of wholesale service quality to CLECs by Verizon VA and Verizon South. However, there is the potential for substantially reduced industry involvement in the VA Performance Standards and VA PAP with the elimination of MCI (and AT&T) as unaffiliated entities of ILECs.

Predicting Service Quality Post-Merger

In an effort to determine the effect of the proposed merger on the adequacy of service going forward, we sent the Petitioners a series of interrogatories regarding downsizing. Exhibit 8 is a supplemental interrogatory response in which the companies stated they were committed to retaining a workforce sufficient to meet the Commission's current or future service quality standards. According to Exhibit 8, the projected merger-related workforce reduction of 7,000 will come from shared resources such as legal, finance and human resources. Specific workforce plans have not yet been established.[30]

[30] The Petitioners acknowledge that they "have not engaged in any post-transaction planning" (see Exhibit 8).

Another consideration is whether the Petitioners' capital investment and maintenance programs will be altered in such a manner as to impair or jeopardize adequate service. One would expect that the vast majority of the Commonwealth's local service telecommunications infrastructure belongs to or is operated by Verizon VA and Verizon South, and that a significant portion of the long distance infrastructure belongs to or is operated by MCImetro. Since the act of communicating is, by definition, two-way in nature, even those customers not subscribing to local and long distance services directly from Verizon VA, Verizon South, and MCImetro are necessarily dependent on the quality of their respective networks. In other words, these companies are extremely important to Virginia consumers. While the Staff does not track MCImetro's investment and maintenance program as it relates to its local service offerings,[31] we do monitor those of Verizon VA and Verizon South.

Information provided annually (as a result of the BA/GTE merger) to the Staff shows that Verizon VA's and Verizon South's capital and maintenance expense spending has remained relatively constant for the last three calendar years (2002-2004). Part B of this Report points to some potential financial concerns; however, assuming that Verizon's financial resources remain sufficient, we expect Verizon VA and Verizon South to continue to invest in a manner that ensures adequate service in their entire service areas, including those with traditional copper-based technologies.

[31] The vast majority of MCImetro's local service customers are served via a UNE-P (unbundled network element – platform) arrangement. Hence, Verizon VA and Verizon South are already the underlying network providers for most of MCImetro's local service customers.

Concerning current service quality performance, as previously mentioned, all three companies are within the Commission's complaint threshold, yet there have been instances where certain other service results have been unsatisfactory.[32]

In terms of predicting the effect of the proposed merger on the adequacy of service, as mentioned previously, the Petitioners state in response to a Staff interrogatory (Exhibit 8) that they intend to retain a workforce sufficient to meet the Commission's current or future service quality standards. Of course, only time will tell. We are also generally satisfied that we have the tools to evaluate Verizon's continued investment in its network. In the BA/GTE merger proceeding, the Commission ordered the companies to "submit the report of [Verizon VA's and Verizon South's] planned and prior year investment and maintenance activity...."[33] This is an on-going obligation with which Verizon VA and Verizon South have complied.[34] In addition, the Staff conducts annual capital investment and maintenance expense review meetings with Verizon VA and Verizon South.

The Staff suggests that if the Commission approves the merger, it should require that Verizon VA and Verizon South respond to and, where possible, resolve Commission complaints within ten business days.[35]

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[32] The Staff is not as concerned with the unsatisfactory performance results in the customer contact related standards in that we have proposed more lenient standards in Case No. PUC-2003-00110 (Establishment of Rules for Service Quality Standards for the Provision of Local Exchange Telecommunications Services).

[33] Case No. PUC-1999-00100, Order Approving Petition, Ordering Paragraph 9.

[34] This is a reporting requirement only and not one that requires a specified level of investment.

[35] The Staff has also chosen to address this continuing problem more formally in Case No. PUC-2003-00110 (Establishment of Rules for Service Quality Standards for the Provision of Local Exchange Telecommunications Services). If adopted as proposed, companies would be required to resolve Commission complaints in ten business days.

Additional Staff Issues

Sufficiency of Application

We have concerns about the sufficiency of the Petition in determining whether the proposed merger meets the standards of Va. Code § 56-90. A large portion of the Petition discusses the changing industry marketplace (i.e. cable, broadband, VoIP, wireless) in an effort to explain why the merger "makes sense and why it will benefit a broad spectrum of customers."[36] The Petitioners apparently recognize that this "global" discussion has little impact on the standards that the Commission must apply in considering this merger pursuant to Va. Code § 56-90.[37] There is little, if any, Virginia specific analysis provided in the Petition, nor does it address any potential impact on the Petitioners' wholesale customers.

The Petition uses language from Staff Reports regarding other mergers and somehow apparently concludes that there should be no problem in this case. Furthermore, the Petition specifically concludes that enterprise customers will not be harmed but provides no Virginia specific references or analysis. The Petitioners claim that residential and small business customers in Virginia will not be adversely impacted because rates and service quality are still subject to the same regulation and consumers will still have choices. There is little, if any, discussion on the impact on competition or the wholesale market in Virginia.

We raise this issue about the sufficiency of the Petition for several reasons. First, we recognize that it is not "unique" for an initial Petition to be relatively general in nature and,

[36] Petition, p. 19.

[37] Petition p. 19.

therefore, the Staff must often rely on responses to interrogatories[38] and comments from interested parties in evaluating a merger petition. However, this practice does not shift the burden of proof to the Staff and/or the interested parties in determining whether a proposed merger in is compliance with the necessary statutory requirements. Furthermore, such an approach puts the Staff, interested parties, and the Commission in a difficult situation if a proposed merger is controversial and/or needs substantial evaluation because of the statutory timeframe required for review.[39] Nonetheless, if the Commission does not have sufficient information or foundation to determine that it is "satisfied that adequate service to the public at just and reasonable rates will not be impaired" it should not grant the Petition. In fact, this is what the Commission determined regarding the BA/GTE merger in Case No. PUA-1998-00031.[40] In its Final Order in that case the Commission said it was:

> ...unable to find in the record evidence or information sufficient to enable us to meet the statutory standard of Code § 56-90 that we "... be satisfied that adequate service to the public at just and reasonable rates will not be impaired or jeopardized by granting the prayer of the petition [.]" We make no finding that rates or services will be impaired by the merger but simply reiterate that the state of the record prevents our conclusion that adequate service at just and reasonable rates will not be impaired or jeopardized. (p. 16)

In addition, the Commission in that Order rejected the Petitioners' theories that their filing shifted the burden of proof to the Staff and others and recognized that the burden of proof fell to the Petitioners.[41] The Order further stated:

[38] Of course, the interrogatory responses are not part of a petition. Further, based on their responses, the Petitioners believe that most of our interrogatory questions were irrelevant.

[39] Va. Code § 56-88.1 requires the Commission to approve or disapprove a Utilities Transfer Act petition within 180 days of filing (assuming all allowable extension periods).

[40] Joint Petition of Bell Atlantic Corporation and GTE Corporation, ("BA/GTE merger") Final Order dated March 31, 1999. The Commission later approved the BA/GTE merger in Case No. PUC-1999-00100.

[41] Final Order in Case No. PUC-1999-00100, p. 16, footnote 4.

> … the record before us does not provide a basis to support the required finding. Petitioners filed an application, unsupported by testimony or economic studies or analysis, which simply declared that its approval would not impair rates or service… Petitioners simply have not provided evidence or information sufficient to show how they will assure the continuation of adequate service to the public at just and reasonable rates if they are allowed to combine. The "record" such as it is in support of the petition, consists almost entirely of argument of counsel. (p. 17-18)

Interconnection Agreements

Several parties raise various concerns about the availability of interconnection agreements. However, one issue that has not been specifically discussed by other parties[42] is the filing of any commercial agreements between Verizon VA and/or Verizon South, and MCImetro. The Petitioners, in a response to a Staff interrogatory,[43] state that they intend to continue offering/purchasing interconnection arrangements and network elements among themselves through interconnection agreements negotiated through § 252 of the Act and not affiliate arrangements. We believe this is appropriate because Verizon VA and Verizon South (and the carriers involved) are required to file and seek approval of such agreements from this Commission. Further, any such agreements would be publicly available for review and adoption by other parties. However, in response to another Staff interrogatory,[44] the Petitioners stated that MCImetro has signed both an Interim Agreement for UNE-P replacement services and, subsequently a Wholesale Advantage Agreement, which supersedes the Interim Agreement. Neither of these "commercial" agreements has been filed with the Commission (as either separate agreements or amendments to existing interconnection agreements). According to that same response, "The Wholesale Advantage Agreement itself will not be filed with the

[42] Although, the Consumer Counsel's comments touch on this issue at p. 11.

[43] Response to Staff Interrogatory No. 3.

[44] Response to Staff Interrogatory No. 36.

Commission because it is not a 252 interconnection agreement." A copy of this response is attached as Exhibit 9. We are not addressing whether or not, as a general premise, these types of commercial agreements need to be filed with the Commission pursuant to the Act. However, we believe that any agreements affecting interconnection arrangements between Verizon VA and/or Verizon South and MCImetro (and any other MCI affiliates that purchase interconnection services) in Virginia should be at least filed with this Commission if the merger is approved.[45] The Commission could require such through either its authority over affiliate agreements as discussed in Part A of this Report or pursuant to VA Code § 56-482, which addresses circumstances under which agreements between telephone companies shall be submitted to the Commission.

Without such a requirement, neither the Commission nor other CLECs would be able readily to ascertain whether Verizon VA and/or Verizon South would be offering superior rates, terms and/or conditions to its newly acquired affiliate, MCImetro, thereby, putting other nonaffiliated CLECs at a competitive disadvantage.

Enterprise Customers

The Petitioners claim that large enterprise, government, and broadband market segments will benefit directly[46] from the proposed merger. The Petition makes clear that an important reason for Verizon's decision to acquire MCI, was to "accelerate its expansion" into the enterprise market and recognizes that MCI has already obtained considerable success in this market. It maintains that Verizon has only a small share of the enterprise market.

[45] This is in addition to the recommendations on affiliate agreements in Part A.

[46] Petition, p. 2.

The Petition argues that the merger won't harm enterprise customers and that the "enterprise segment has long been considered the most competitive and it will remain so even when the transaction is completed."[47] We don't argue here with this general global premise; however, MCI is likely the most prominent provider of intrastate telecommunications services to enterprise customers in Virginia. As noted previously, MCI provides services to state government under the COVANET contract.[48]

While the Commission does not have authority over services provided to the Commonwealth, there are still several relevant concerns. First, there is the basic issue that the discussion in the Petition is global in nature and provides no specifics or analysis on the potential impact on the enterprise marketplace in Virginia. Therefore, the general arguments that enterprise customers will continue to receive adequate service at just and reasonable rates and that "adequate service"[49] to large businesses will be enhanced should carry little weight in evaluating whether the merger meets the required statutory requirements in Virginia.[50] Second, Verizon VA and Verizon South relied heavily [redacted] in seeking classification of their intrastate Frame Relay and

[47] Petition, p. 21.

[48] In addition, it is our understanding that MCI may also serve nongovernment customers through its COVANET network.

[49] Petition, pp. 22-23.

[50] In response to a Staff Interrogatory, the Petitioners attempted to quantify the amount of competition for enterprise customers based on growth of high capacity loops and other more general information.

[51] There is no mention of the Commonwealth of Virginia as a specific enterprise customer served by MCI in the Petition or responses to interrogatories.

ATM services as competitive in Case Nos. PUC- 2004-00141 and PUC-2004-00142.[52] In fact, based on information provided in both cases (and supplemented in this case in response to Staff Interrogatory No. 40), Verizon VA and Verizon South identified that the actual competitive revenue losses for both ATM and Frame Relay in Virginia [redacted] Therefore, considering Verizon VA's and Verizon's South's competitive loss analyses that it provided for ATM and Frame Relay services, the proposed merger would apparently result in eliminating Verizon VA's and Verizon South's largest and most effective competitor for ATM and Frame Relay services in Virginia. As noted earlier, the Petition does not include a specific analysis on the impact on enterprise customers in Virginia. Therefore, if the market becomes considerably less competitive, it could be of significant consequence since Verizon VA and Verizon South presently have no pricing constraints on their intrastate ATM[53] and Frame Relay services. Therefore, it is possible that the prices for these intrastate services for enterprise customers in Virginia could exceed market-based rates and, in effect, fail to be "just and reasonable."

A possible approach to help counter this concern would be to require Verizon VA and Verizon South to file to reclassify these services as an Other Local Exchange Telephone Services ("OLETS") under their ARP. This would not impact pricing for these services (or any others) to state government but could protect other jurisdictional customers if necessary. Verizon VA and Verizon South would not be harmed because they could still use ICB pricing authority under the

[52] Application of Verizon Virginia Inc. to Reclassify ISDN PRI Service (IntelliLinQ) and its associated Features, ATM Cell Relay Service and Frame Relay Services as Competitive under its Plan for Alternative Regulation, and Application of Verizon South Inc. to Reclassify ISDN PRI (IntelliLinQ) and its associate Features and Frame Relay under its Plan for Alternative Regulation. Orders in both cases dated February 16, 2005.

[53] ATM was only made competitive for Verizon VA. Verizon South did not seek to reclassify ATM service as competitive.

ARP in competitive situations. In addition, Verizon VA and/or Verizon South could later submit an application to reclassify these services as competitive.

We suspect that Verizon VA and Verizon South will argue that their ARP already contemplates procedures for parties seeking to reclassify services into other categories, and therefore, if there is a competitive concern, it can be dealt with through that process at a later date.[54] While we recognize that the ARP allows for any interested party to petition to reclassify Verizon VA or Verizon South services, we do not believe that this satisfies this concern for several reasons. First, the Petitioners made no attempt in their Petition to address this issue. Second, if the proposed merger would result in a less competitive market (and potentially impacts rates) for ATM and Frame Relay it should be addressed in this proceeding and not some potential future case. In addition, and particularly important, in a reclassification case under the ARP, the petitioning party would have the burden of proof instead of Verizon VA and Verizon South.

We cannot necessarily conclude from this discussion that the enterprise market in Virginia (particularly Frame Relay and ATM services) will be significantly harmed in Virginia as a result of the proposed merger; however, we do not believe that the Petitioners have put forth any Virginia-specific evidence from which the Commission could determine that it can be reasonably assured that such services will not be harmed.

Triennial Review Remand Order

Earlier this year, the Federal Communications Commission ("FCC") determined in its TRO Remand Order[55] that certain high capacity UNEs in some situations no longer need to be

[54] ARP at Section D, paragraph 4.

[55] The FCC's Order on Remand ("TRO Remand Order"); WC Docket No. 313 and Docket No. 01-338, released February 4, 2005. (FCC 04-290)

made available by ILECs because other telecommunications carriers were not impaired without access to them. Specifically, the TRO Remand Order states that ILECs were no longer required to (i) offer DS1 loops in any building location that is served by a wire center with at least 60,000 business lines and four fiber based collocators; (ii) offer DS3 loops in any building location that is served by a wire center with at least 38,000 business lines and four fiber based collocators; (iii) offer dedicated DS1 Transport between any pair of an ILEC's wire centers that each serve at least 38,000 business lines or have four fiber based collocators; (iv) offer dedicated DS3 Transport between any pair of an ILEC's wire centers that each serve at least 24,000 business lines or three fiber based collocators; and (v) offer Dark Fiber Transport between any pair of wire centers that each serve 24,000 business lines or three fiber based collocators. Verizon sent a letter to the CLEC industry in Virginia and elsewhere in its service footprint (and filed information with the FCC) laying out this criteria and providing access to a document that identifies the interoffice routes where CLECs are not impaired without access to DS1, DS3, and Dark Fiber Transport, as well as the wire centers that satisfy the TRO criteria for nonimpairment. A copy of the letter to CLECs from Verizon's website and its wire center analysis (for Virginia) is attached to this Report as Exhibit 10.

Verizon's wire center analysis shows that the availably of high capacity loops and transport in Virginia is impacted by the FCC's TRO Remand decision. We are not disputing the outcome of this analysis; however, in a Staff interrogatory, we requested information that sought the results if MCI was excluded from the wire center exemption analysis. Verizon objected to this interrogatory; however it still provided the requested information. Exhibit 11 is Verizon's response and attached confidential analysis document. This document shows that, without

MCI's fiber-based collocation arrangements included in the analysis, there would be different results on the availability of certain high capacity UNEs in several wire centers.

In its response to the Staff interrogatory, Verizon stated that, under the FCC's rules, it is not obligated to remove any wire center from its impairment analysis once it has qualified under the FCC's nonimpairment thresholds.[56] We are not disputing this point (the FCC can deal with its own rules). However, our concern is the impact on competition and rates in Virginia. As several interested parties point out, to the extent that the merger removes MCI as an alternative potential dedicated transport provider, this could have consequences on competitors[57] and the prices they pay for such transport. Interested parties suggest a number of conditions, in part, to counter this concern such as requiring the divestiture of MCI's dedicated transport facilities[58] and/or preventing Verizon VA and Verizon South from increasing its special access rates.[59] While we have not taken a position on all these suggestions at this time, we believe that, at a minimum, Verizon should agree to modify its wire center analysis excluding MCI as a fiber-based collocator and to make any newly determined high capacity UNEs available in those affected wire centers in Virginia. We also believe such a requirement can support the public interest goal under § 235.5:1 (ii) to "promote competitive product offerings…in all areas of the Commonwealth…."

If the Commission is reluctant to require this further unbundling of high capacity UNEs in light of the Act and FCC requirements, we believe it has several options. First, of course, Verizon may agree to accept this requirement as a condition for approval of the proposed merger

[56] We note, however, that the FCC's TRO Remand Order required that the initial wire center analysis be done excluding the ILEC's affiliates collocation arrangements.

[57] And potentially on the availability (and prices) of their services to their customers throughout the Commonwealth.

[58] For example see Cavalier's Comments at p. 7 and Qwest's Comments at p. 21.

in Virginia. Alternatively, the Commission could defer (or if necessary, deny) considering the proposed merger until after the FCC and DOJ have finished their reviews (see further discussion later in the Report). Furthermore, the Commission could require Verizon to raise this issue with the FCC.

Costs and Savings

The Petition only references possible "financial benefits" that may result from the merger with no specific details of any cost savings.[60] Furthermore, in response to a Staff Interrogatory, the Petitioners were unable to provide details of any costs and savings from the merger on a Virginia state level (see Exhibit 12). In regards to the BA/GTE merger, ordering paragraph (1) of the Commissions' Final Order in Case No. PUA-1998-00031, stated:

> Petitioners must provide information to the Commission that sets out expected cost and savings attributable to the merger, for both BA-VA and GTE-South ...We find that since both BA-VA and GTE South provide service in Virginia, we must be satisfied that neither BA-VA nor GTE South's, ability to provide such service at just and reasonable rates will be impaired or jeopardized. Therefore, we direct the Petitioners to provide the information set out in this paragraph with respect to both BA-VA and GTE South.

The pricing provisions of the ARP neither require Verizon VA nor Verizon South (nor MCImetro under the Local Rules) to pass any Virginia specific cost savings (from any source) along to its customers. Furthermore, we are not suggesting that the Commission require cost savings information, such as that required with the BA/GTE merger, in order to proceed with our review of the proposed merger. However, if Verizon VA and Verizon South were to be subject to any cost or other rate proceeding in the future, the merger costs and savings information may

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[59] See for example, Qwest's Comments, pp. 15 and 18 and XO/Covad Comments at pp. 29-31.

[60] Petition, pp. 18-19.

be helpful and/or necessary to assist the Commission in making its decision. In addition, Verizon VA and/or Verizon South could file (or the Commission may determine their current ARP doesn't met the statutory requirements) to change its current form of alternative regulation at some point in the future. In such an evaluation of a new regulatory plan, the Commission may need the information to assist it in determining compliance with the statutory criteria of Va. Code § 56-235.5, such as continued affordability of rates and whether the proposed plan is in the public interest. In addition, there is the potential for cost shifting among affiliated entities that could potentially harm customers and/or competitors in Virginia.[61] Therefore, we suggest that the Petitioners track the merger costs and savings for the Virginia entities for a minimum of three years[62] after the merger is consummated to ensure that this information is available if needed in the future. Presumably the Petitioners will already do this for internal or other reasons. However, we are not suggesting that the Companies file this information with the Commission or the Staff on an ongoing basis but only have the information available upon request in the appropriate proceeding.

<u>BLETS and OLETS Rates</u>

The Consumer Counsel suggests, as a condition for merger approval, that the Commission consider limiting (at least temporarily) any subsequent rate increase by Verizon VA and Verizon South under their ARP.[63] The Consumer Counsel offers that the Commission could

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[61] For example, if merger costs are inappropriately shifted to Virginia entities and any of those entities (or exchanges) are spun off (or their assets sold) this could result in increased costs that may ultimately need to be borne by Virginia ratepayers.

[62] The Petitioners have not provided information on the "life" of potential cost savings. In Case No. PUC-1999-00100, the Commission in approving the BA/GTE merger required the submission of ongoing information for a minimum of five years.

[63] Consumer Counsel Comments, pp. 8-9. Verizon VA and Verizon South are increasing various BLETS and OLETS rates effective September 1, 2005.

limit increases in the BLETS price ceilings to one-half the Gross Domestic Product Index ("GDPPI") rather than the full amount, and limit future increases to BLETS (under the ceiling) and OLETS to 5 percent annually rather than the currently allowed 10 percent. We recognize that the Commission has only recently determined "affordable" BLETS rates for Verizon VA and Verizon South under their ARP. Further, Verizon VA and Verizon South were ordered to make additional Commission switched access reductions on February 1, 2006, in Case No. PUC-2003-00091. Any potential BLETS and/or OLETS pricing limitations should consider this situation.[64] Of course, we expect that Verizon VA and Verizon South will oppose these proposed conditions, claiming that they have nothing to do with the statutory standards of Va. Code § 56-90. To the extent that the Commission finds that the Petition itself is insufficient to determine whether the merger will or will not jeopardize adequate service at just and reasonable rates, it may want to consider adopting conditions that would be in the public interest in order to offset any possible concerns (or insufficiencies) as an alternative to denying the request outright. As an example, as pointed out in Part B of the Report, the proposed merger could have a negative financial impact on the combined Verizon by potentially reducing its bond rating and tying up (or diverting) its financial resources. This might not be an unreasonable risk for Verizon, as a whole, to take on. However, if it occurs, it could have a negative impact on consumers and service quality in Virginia (particularly short term). For instance, it is possible that this could result in future Verizon VA and/or Verizon South rate increases (albeit not in violation of their ARP) that would not have occurred absent this merger.

We also believe that it is possible that prices for BLETS and OLETS could be impacted by this merger if the competitive market is sufficiently diminished so that Verizon VA and/or

[64] MCImetro and Verizon's long distance affiliates benefit substantially from the Commission ordered access reductions.

Verizon South have less competitive pressure on their rates. We are not suggesting that they would become "unaffordable." However, they could become less affordable if market forces are no longer effective in mitigating prices. This is an additional reason why the competitive impact on Virginia is so important in evaluating the proposed merger. We have heard from several competitors about their concerns in the wholesale marketplace but there can be effects in the retail marketplace as well. As mentioned previously, the Petitioners provided little if any Virginia specific competitive analysis in their Petition.[65] The Commission specifically recognized in Case No. PUA-1998-00031 (BA/GTE merger) that it was necessary for the Petitioners to address any effect of that proposed merger on telecommunications competition in Virginia.[66]

Federal Review

The FCC and the DOJ are also reviewing this proposed merger. Their reviews will likely involve issues outside the evaluation and/or jurisdiction of this Commission. We believe that both the FCC and DOJ will be particularly interested in the impact on telecommunications competition from a more national or global aspect and may even address some of the conditions proposed by interested parties in this proceeding.[67] However, any federal conditions could have a positive or negative impact on Virginia customers. For example, the DOJ could require Verizon and MCI to divest some of their facilities (i.e. access lines) where there are either overlapping facilities or where the combined market concentration of the companies exceeds

[65] The Petitioners provided some additional information in response to a Staff interrogatory; however, that is not part of the Petition nor was it supplemented with this response.

[66] In fact, ordering paragraph 6 in the Final Order denying approval required this information in any subsequent filed application. This requirement was even ordered prior to the adoption of VA Code § 56-235.5:1.

[67] The FCC in approving several major past mergers has had conditions attached.

some threshold. While this may be a reasonable global condition, it could have a detrimental impact in Virginia.[68]

Fully evaluating the impact of the merger in Virginia may be somewhat fruitless without knowing what, if any, federal conditions may be applied. Therefore, the Commission may want to consider deferring its final "approval" of the merger, or in the alternative, condition any approval subject to a further review of any federal conditions.[69]

Evaluation of Va. Code Section 56-235.5:1

In its May 5, 2005, Order, the Commission requested parties to comment on whether any provisions of Va. Code § 56-235.5:1 are applicable to the Petition. The Petitioners do not directly address the applicability in their Petition; however, in response to Staff Interrogatory No. 2, they claim it does not apply. Exhibit 13 is a copy of the Petitioners' response. Several interested parties addressed this issue and all state that the statute applies. We agree it applies.[70]

Va. Code § 56-235.5:1, Local exchange telephone service competition policy, is a fairly recent legislative addition (2004) that states:

[68] If less than 100 percent of the intrastate telephone company assets are divested, there is no requirement for review under the Utilities Transfer Act.

[69] Contingent conditions have been adopted in other cases. See for examples Case No. PUC-1999-00100 and Case No. PUC-2004-00146.

[70] See Office of General Counsel's legal memorandum filed in conjunction with this Report.

> The Commission, in resolving issues and cases concerning local exchange telephone service under the federal Telecommunications Act of 1996 (P.L. 104-104), this title, or both, shall, consistent with federal and state laws, consider it in the public interest to, as appropriate, (i) treat all providers of local exchange telephone services in an equitable fashion and without undue discrimination and, to the greatest extent possible, apply the same rules to all providers of local exchange telephone services; (ii) promote competitive product offerings, investments, and innovations from all providers of local exchange telephone services in all areas of the Commonwealth; and (iii) reduce or eliminate any requirement to price retail and wholesale products and services at levels that do not permit providers of local exchange telephone services to recover their costs of those products and services.

In this case, at least two principles may come into play in evaluating the Petition. The first requirement, that the Commission treat all providers of local exchange telephone services in an equitable fashion and without undue discrimination,[71] may apply to this proposed merger because of the concern over the potential relationship between Verizon VA, Verizon South and MCImetro. As mentioned previously, Verizon VA and Verizon South (as ILECs) could have an incentive to favor their own affiliate to the detriment of other CLECs. This possibility may be seen as a reasonable basis for the Commission to apply different requirements to the companies involved in this proposed merger, than it might otherwise adopt in other cases (or in conjunction with nonaffiliated entities).[72] This "preferential treatment" concern can be somewhat mitigated by requiring notice of affiliate agreements (for some period of time) and filing interconnection agreements with this Commission (including commercial agreements) between Verizon VA or

[71] Applying the same rules to all providers is less relevant; however, to the extent that different requirements are adopted as a condition of a merger, we assume that such would be warranted and allowable on the provision to the greatest extent possible."

[72] We do not believe that such action, if necessary, would be inequitable.

Verizon South and MCImetro (and any other MCI affiliate purchasing interconnection services in Virginia).

The second provision of Va. Code § 56-235.5:1, which addresses promoting competitive product offerings, investment, and innovations from all local exchange providers throughout the Commonwealth, is particularly applicable. To the extent the merger results in lessened competition and/or reduces the availability of certain wholesale products, it could in effect limit such instead of promoting it. Such a result does not necessarily mean that, if analysis of a merger raises competitive concerns, it must be denied. There are alternatives to such action, such as conditions on the approval.[73]

Conclusion

The Staff is not convinced that the Petitioners have met their burden of proof for the Commission to be satisfied that "adequate service to the public at just and reasonable rates will not be impaired or jeopardized" by the proposed merger. Therefore, we suggest the Commission consider two alternatives. First, it could disapprove the Petition without prejudice for the Petitioners to refile with additional and sufficient information as it previously did in Case No. PUA-1998-00031. Or alternatively, the Commission could approve the Petition, subject to the appropriate conditions that ensure adequate service to the public at just and reasonable rates will not be impaired or jeopardized.

[73] The Commission has taken such action in the past. For example, see Commission conditions placed on the merger of Bell Atlantic Corporation and GTE Corporation in Case No. PUC-1999-00100, Final Order dated November 29, 1999.