

CLACKAMAS COUNTY BOARD OF COUNTY COMMISSIONERS
Staff Presentation Worksheet

Presentation Date: December 22, 2009 Time: 11:00 AM Length: 30 minutes

Presentation Title: Application by Verizon Northwest, Inc. for Consent to a Transfer of Control of the Cable Franchise Agreement to Frontier Communications Corporation

Department: PGA/Cable Communications

Presenters: Debbie McCoy, Cable Manager; Heather Martin, Special Counsel, Beery, Elsner and Hammond, LLP;

What direction does the Board want to take on the application by Verizon Northwest Inc. (Verizon Northwest) for consent to a transfer of control of the cable franchise agreement to Frontier Communications Corporation (Frontier)?

Recommendation: After reviewing the proposed transfer of control of the Verizon Franchise within the strict framework of Federal Law, staff has determined that Frontier has the legal, financial, and technical qualifications to own and operate the FiOS cable system. The Metropolitan Area Communications Commission (MACC) coordinated efforts and shared resources with the County and several other jurisdictions in this review which included a technical review completed by MACC and a financial review done through the efforts of the Mt. Hood Cable Regulatory Commission (MHCRC). Both MACC and the MHCRC have now recommended approval to their jurisdictions. It would be staff's recommendation that this transfer of control of the Verizon Franchise to Frontier Communications Corporation (Frontier) be approved.

Summary

On December 4, 2008, Clackamas County granted Verizon Northwest Inc. a fifteen-year cable franchise agreement which expires on December 4, 2023. On May 13, 2009, Verizon Communications Inc., (Verizon Communications) the parent company of Verizon Northwest Corporation. The sale includes all of Oregon and Washington and 12 additional states. Verizon is not selling its business and wireless services. This \$8.6 billion transaction (\$5.3 billion in stock and \$3.3 billion in new debt) is set to close in the second quarter of 2010. Largely arranged in this way for tax purposes, the sale involves the transfer of the current subsidiary (Verizon Northwest) to a new parent corporation (from Verizon Communications to Frontier). (See Frontier Announcement in Exhibit A).

On June 1, 2009, Clackamas County Cable Communications received a Federal Communications Commission (FCC) Form 394 Application from Verizon Communications. This submittal formally requests the transfer of control (transfer) to Frontier under Federal Law.

On June 8, 2009, Ann Burr, President and General Manager of Frontier Communications of Rochester, NY, met informally with the County to introduce Frontier. Staff was told that Frontier, headquartered in Stamford, Connecticut, offers wireline telephone and broadband service to approximately 2.3 million access line subscribers in 24 states. The City of Rochester (population 220,000) is its largest single holding. The proposed transaction will result in Frontier

tripling in size to hold over 7 million access lines in 27 states. Most of Frontier's service (voice, Internet, broadband) are provided in rural and suburban areas.

By way of comparison, Frontier is the 19th largest telephone provider in the US and Verizon communications is the 2nd largest. Both Verizon Communications and Frontier are publicly traded companies.

The Review Process – Federal Law sets out a very specific and limited review of a proposed transfer for local governments. The Federal Law allows local franchising authorities to inquire into the legal, financial, and technical qualifications of the prospective transferee. The franchising authority may condition the transfer upon such terms and conditions as they deem reasonably appropriate, but these must relate to an incoming company's legal, financial, and technical qualifications. Federal Law also provides the County a 120-day period of time to complete its review, once the County deems the application is complete.

By contrast, state Public Utility Commissions including the Oregon PUC can and do undertake a much more comprehensive review with respect to the aspect of this transaction affecting telephone services. State law and administrative rules - not Federal Law - govern the OPUC's review. In part, this different and more rigorous regulatory structure derives from the fact that continuous and complete provision of telephone service is required by law, including the provision of E911 services and related funding.

Verizon Communications' June 1, 2009 Application was submitted with incomplete explanation and details. As a result, staff was unable to determine, based on the information presented in the Application, that Frontier had the necessary qualifications to assume the Verizon Franchise. Therefore, on June 25, 2009, the County submitted an 18-page formal Request for Information (RFI) to the companies as authorized by Federal Law, seeking complete information and clarifications about the proposed transaction. On July 3, 2009, Verizon and Frontier provided their first response to the County's RFI.

Review of the Proposed Transfer – The County worked with the companies and MACC who employed legal counsel and technical and financial consultants to fully review this transaction. This was done in order to save time and resources. This review included the cities of Happy Valley, Newberg, Wilsonville, and Sherwood as well as the MACC jurisdictions, Clackamas County and the MHCRC. MHCRC represents four Verizon cities in East Multnomah County. On behalf of all partners, MACC hired CBG Communications to perform a technical review of Frontier; and the MHCRC hired KFA Services to perform a financial review. Since MACC, the MHCRC, Happy Valley, Sherwood and Clackamas County all contract with Beery, Elsner and Hammond for legal advice, the collaboration saved everyone money for the legal work needed to complete this process. In addition, MACC and the MHCRC also communicated with several Seattle area jurisdictions that were considering this transaction.

Commitment to the Franchise – Frontier is currently a telephone and Internet company – they have no current video experience, except through their partnership with the unregulated, unfranchised, satellite company Dish Network. Frontier operates no cable systems anywhere, and the few that the company had acquired over the years were quickly divested. Because of this history, concerns arose about Frontier's long term commitment to cable and the Franchise, especially in light of Section 13.9 of that agreement. Section 13.9 could provide Frontier with an opportunity to terminate its obligations under the cable Franchise within 18 months of the proposed close of the transaction.

The documents we have obtained through the extensive process described above show that Frontier has committed to the video business, through investment in equipment, planning and agreements to lease capacity and otherwise create the required network elements to transport video signals. (See MACC Technical Concerns, below.) Staff believes these actions show that Frontier will be ready to provide cable service upon the close of the merger transaction, and intends to provide the service long-term.

Furthermore, as part of our examination of Frontier's finances going forward, we understand that there are substantial financial benefits to Frontier from offering its own cable service using the FiOS structure. There are no comparable benefits from partnering with a satellite provider.

County's concern for Section 13.9 of the Franchise which was a standard provision of all Verizon franchises which allowed them to "walk away" from poorly-performing franchises has been handled through a separate "side-letter" provided by Frontier (see Exhibit B of Report – "Frontier Side-Letter") stating, it "...does not intend to exercise..." this provision of the agreement.

Technical Concerns – Company representatives said they were working on an agreement to continue to use Verizon to transport programming signals from Florida (the collection site for Verizon's video system), and build an additional facility in Illinois to move those signals to the new Frontier franchises. However, this plan was not certain. Frontier also had two back up plans (as described in their Aug. 3 response to the County's RFI).

This uncertainty revealed that the companies were still quite early in the process of determining how they would provide cable service to the franchise area. Because the transfer review process is centered on the *technical qualifications* (as well as legal and financial qualifications) of the incoming company, staff was quite concerned. Among the outstanding technical uncertainties: 1) there was no specified arrangement for gathering and distributing video programming signals; 2) there were no agreements with programmers to provide content; 3) there was no demonstrable plan to retain critical Verizon employees following the merger; and, 4) there was no clarity about how customer service would be managed by Frontier.

Because these concerns were echoed throughout by our neighboring jurisdictions and specifically MACC who was leading this effort, the companies agreed to extend the timeline to complete the review to November 30, 2009. The September 10th MACC Commission meeting which staff attended, focused on the Frontier/Verizon transfer, especially Frontier's technical abilities. Ms. Burr, Mr. McCallion, and Frontier's Vice President of Technology, Michael Golob, presented updates and additional information. We were told that Frontier had settled on a plan to build or lease a network to distribute video content to its video hubs in Oregon, Indiana, and Washington. Further, Verizon Communications and Frontier planned to construct a facility at Verizon Communication's Super Headend (SHE) in Illinois to provide this critical service. Frontier also told MACC Commissioners that programming agreements were being negotiated, but were slow in coming. With respect to staffing, Frontier provided greater detail on their plans to acquire Verizon Staff and fill vacancies that might develop. They also discussed how they would manage customer service and subscriber calls.

At this meeting, Frontier was told that, in order to back up Frontier's claim that it had the technical qualification to assume the Franchise, MACC would need to see the following before their Commissioner could make a decision on the transfer application: (1) a transport agreement between Verizon Communications and Frontier, (2) that fiber leases were in place to carry content from their main facility in Illinois to Oregon, and (3) that significant programming was under contract. MACC set a date of September 25th as the deadline for the companies to

provide this information in order for them to hold a special meeting in October to consider a recommendation on the transfer.

When it became clear that the transport agreement and leases would not be completed by the September deadline, the companies agreed to a second extension to January 31, 2010. The following company submittals and staff reviews were continued throughout October:

- A thorough explanation of how Frontier will receive and distribute cable programming.
- An explanation of Frontier's efforts to secure programming from content providers, and a commitment by Frontier to keep staff fully informed during the approval process and through the time Frontier begins providing service.
- A staff review (performed by MACC) of internal, confidential documents detailing the relationship between Frontier and Verizon Communications, including the service and mechanics required to ensure the long-term viability of cable service from Frontier.
- Frontier's cooperation with the MHCRC financial consultant, resulting in the KFA Service report on Frontier's financial ability to assume the franchise obligation.
- Other information clarifying Frontier's plans for customer service and acquired Verizon employees.

By the first week of November, following the submittal of the above information to MACC, and further review by MACC staff, it was found that there was sufficient documentation of the legal, technical, and financial information required to make a recommendation.

Review of Frontier's Legal, Technical, and Financial Qualifications

Staff and consultant review of Frontier's legal, technical, and financial qualification to own and operate the Verizon cable system resulted in the following findings:

Legal Qualifications – Following the close of the transaction, the current Franchisee, Verizon Northwest, will continue in that capacity after the completion of the transfer to Frontier. Since the actual "Franchisee" is not changing, Frontier expects this fact will speed the process to obtain local telephone, state public utility commission (PUC), Federal Communication Commission (FCC), and Department of Justice clearances to operate the systems acquired. The Oregon PUC is scheduled to hold a hearing on this matter in early December with final decision expected in January 2010. If the Oregon PUC fails to approve Frontier's application, there will be no transfer of cable service.

Frontier's corporate management staff are experienced and come from a variety of telephone, cable, and communications industry backgrounds. Inquiries made regarding the character of Frontier employees did not result in any concerns. There are also no ongoing legal actions or judgments that raise the concerns of staff or legal counsel.

Conclusion: Assuming Frontier obtains the required local, state, and Federal authorization to operate Verizon, we see no legal reasons why the transfer should not take place.

Financial Qualification – Since all past transfers of control/ownership reviewed by staff have involved larger cable companies buying smaller cable companies, the issue of financial qualifications has been a relatively minor concern in prior transfer of control reviews. However, this transaction, in which Frontier, a mid-size telephone company buys a sophisticated cable operation like Verizon FIOS, raised a number of financial concerns.

In considering a company's financial qualification to own and operate a cable system, the first concern is about the incoming company's ability to finance the transaction and to manage its new debt load. A heavily leveraged debt could result in adverse affects to the County (i.e., late or non-payment of franchise fees) or subscribers, possibly resulting in higher service rates, poor customer service, delays in installing plant in new areas, or poor program/transmission quality.

To assist with the financial review, KFA Services was retained by MACC to conduct a financial analysis. Mike Katz of KFA Services has a long association with cable financial analysis for the County. The KFA report, which is based on the information provided by the companies and on KFA's own research, concludes that Frontier "is currently in reasonable financial health, with operating cash flows sufficient to fund on-going capital expenditures" and other operating requirements. Following the acquisition of the Verizon properties, KFA reports, "Frontier should also be in reasonable financial health." KFA is more concerned about the long-term stability of the company, although many of those concerns are affected by circumstances (e.g., the current economy), subject to competitive factors, and uncontrollable by any regulatory or enforcement mechanism. KFA recommends that Frontier provide a corporate guarantee to ensure Franchise performance.

To address KFA's concerns, staff negotiated a specific condition as part of the Board Order for Approval which requires Frontier to provide a new Letter of Credit in the amount of \$25,000 to secure Frontier's obligations under the franchise and to further protect the County. Frontier will provide this additional security for a period of five (5) years from the close of the transaction (to 2015). The Letter of Credit is a new requirement, over and above current obligations in the Franchise, and directly related to the newly structured Franchisee's performance under the Franchise and any potential financial harm the County could face if Frontier fails to perform.

Conclusion: Based on the KFA Services report, staff concludes that Frontier likely has the financial qualifications to own and operate the cable system. However, as additional protection for cable subscribers and the County, staff has negotiated additional financial protection from Frontier for the first five years of their operation of the Verizon Franchise.

Technical Qualifications – The Verizon Communications FiOS system is one of the most technically sophisticated telecommunications systems in the country—it is also a product unique to Verizon Communications on this scale. Our first and largest concern, when we learned of this proposed transfer, was whether Frontier had the technical qualification to own and operate the FiOS system.

To assist in this review, MACC retained the services of CBG Communications, a technical firm we have worked with for years on technical studies provided to the County and most currently the County-wide needs assessment. The following areas were explored: Frontier's experience in operating cable systems; their staff experience in cable; the type of system Frontier planned to operate here; their long-term commitment to video; and above all, the likelihood that Frontier will continue to provide a viable competitive cable service to its customers.

Frontier's Cable Operations Experience – As stated previously, Frontier currently does not operate any cable systems—the last time they operated a cable system was in 2005. Prior to that date, Frontier acquired a number of small cable systems (from 255 to 2,728 subscribers) when they purchased telephone systems. All of these systems were either abandoned, sold, or were no longer operated by Frontier. In some cases, former subscribers to these systems were offered DISH as an alternative. The only video service Frontier currently provides to their telephone subscribers is the DISH Network via satellite. DISH is not a cable service.

However, a key element of their purchase of Verizon is Frontier's planned acquisition of the local staff responsible for the current Verizon cable system. Engineers and technicians have been assured that there will be no layoffs for any reason for at least 18 months after the close of the transaction. Other Verizon employees (unrelated directly to the cable system) are expected to be retained, but have been provided no guarantees.

Staff Experience – Several Frontier corporate executives have held positions in the cable industry, including Ms. Burr. Although that experience is somewhat helpful, it is not particularly relevant to the Verizon cable operation in the County. Frontier will rely on the current Verizon employees to operate the system (see above).

Continuity of the Verizon Cable System – Following extensive discussion with and formal submittals from Frontier and Verizon Communications, we have learned that Frontier will operate the existing cable system in unincorporated Clackamas County in a manner consistent with Verizon's current operations. Frontier's acquisition includes all local system facilities and components. Beyond the local area, Frontier must secure two vital facility components – and we were assured through formal submittals and the review of confidential internal documents that these components have either been, or are in the late stages of being secured. Demonstrated commitments include:

- A newly constructed facility that accepts programming from the existing Verizon video distribution system in Illinois. Frontier has invested considerable time, money, and thought in provisioning this facility.
- An executed "transport agreement" between Verizon Communications and Frontier. This will enable the connection between Verizon Communications and Frontier's facilities in Illinois.
- Dedicated leased fiber network capacity to carry programming from Illinois to Verizon's VHO in Hillsboro (and other video hubs that Frontier is acquiring).

Content – The final, major technical concern related to content. Before it can operate as a cable system, Frontier must acquire the approval, through licensing agreements, of hundreds of cable programming networks. These agreements are necessary in order for Frontier to legally "re-broadcast" those services that all of us have come to expect from a cable provider: e.g., CNN, FOX, ESPN, TNT, DISNEY, HBO. Additional agreements are required to carry local network affiliates: e.g., KATU, KOIN, KGW, PBS, KPTV.

Frontier faces a complicated and delicate negotiation to arrange these contracts, and no commitments have been obtained by Frontier to date. We understand the process Frontier is pursuing and have been assured that these agreements are being negotiated, and will be kept informed on their progress in obtaining these agreements.

Local governments have little oversight under Federal Law of the content delivered over the cable system—it is largely a function of economics and competition. There is no guarantee, and frankly no expectation, that Frontier will duplicate every channel on the current Verizon cable service. Our sole charge is to ensure that Frontier is technically capable of providing a viable cable channel lineup to its customers.

To accommodate the gap between the review period and the actual proof that Frontier has agreements with programmers, Frontier has agreed to condition the transfer on two points:

- A report no later than January 15, 2010 that details the status of all programming agreements.
- A certification, no later than March 31, 2010, by a Frontier corporate office that it has retained at least 75% of the channels currently programmed by Verizon.

Verizon cable customers with long-term contracts who are unhappy with the ultimate Frontier lineup may be able to sever those agreements. Frontier said that they will make every effort to accommodate unhappy customers. Frontier will also provide subscribers and the County with a complete, projected cable channel line-up no later than 30 days prior to the time Frontier assumes operation of the cable system in unincorporated Clackamas County (projected to be in June or July of 2010).

Conclusion – After reviewing Frontier’s telecommunications/cable experience, staff expertise (and Verizon local staff they will acquire), the type of system they plan to operate, their contractual relationship with Verizon Communications, and the assurances provided regarding program acquisition, we believe Frontier has the technical qualifications to operate the Verizon FiOS cable system.

Customer Service

Quality customer service has always been a priority for the County. As a result, the County’s cable franchises, including the Verizon Franchise, have many important customer service provisions. Verizon began offering its FiOS video services in unincorporated Clackamas County in 2009. Verizon currently handles most of its customer calls at its Everett, Washington call center, which Frontier will acquire as part of the transfer. While Frontier will continue this long-distance management relationship with its cable (and telephone/Internet) subscribers, we are told that the company will also employ local managers in the Portland area. Staff views this as a possible improvement over the centralized Verizon system.

Frontier stated that customer service is a priority for the company both at the local and corporate level. We understand that local managers will ensure a more responsive experience for both the County and Frontier’s customers. The local general manager hired will be committed to Frontier’s efforts to “extend its local engagement model to these newly acquired properties.” Under this model, managers have the power and authority to make decisions locally on operations and maintenance, customer service issues, profit/loss, and coordination with local franchise authorities. County staff will be diligent in ensuring this local management model pays off for customers.

Frontier states that it will make effort to make this transition seamless for subscribers. Staff believes this will be a very large hurdle, but in the end, Verizon customers will at least have as many choices and a possibility of improvement due to Frontier’s local management.

Conclusion – Staff believes that Frontier will make a significant effort to provide quality customer service. As a smaller telecommunications provider, they may actually be better suited to serve the County than the very large and centralized Verizon Communications.

RECOMMENDATIONS

If the recommended approval is implemented, the County would continue to have a cable franchise operated by Frontier Communications Corporation on the Verizon FiOS system under the Frontier Northwest name. Although certain risks exist for the County and in some cases for subscribers, staff feels that with the safeguards in the Board Order, the remaining level of risk is acceptable and unavoidable. We understand that Frontier will need to compete in a very

competitive local environment with Comcast, satellite providers, and local broadcast stations. We believe that Frontier should be able to compete in the County and provide better customer service than the much larger Verizon Communications.

If the Board were to deny the transfer, Frontier could challenge the denial in Federal court.

SUBMITTED BY:

Division Director/Head Approval Debbie McCoy
Department Director/Head Approval Harry Schwartz for Elissa Gertler
County Administrator Approval SW

Attachments:

- Exhibits: A – Verizon/Frontier Sale Announcement
 B – Letter from Frontier regarding Section 13.9 Grantee Termination
 C – Board Order for Approval

For information on this issue or copies of attachments, please contact Debbie McCoy @ 503-742-5902