Decision **ALTERNATE DRAFT DECISION OF COMMISSIONER BROWN**
(Mailed 11/3/2005)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Joint Application of Verizon Communications Inc. (Verizon) and MCI, Inc. (MCI) to Transfer Control of MCI's California Utility Subsidiaries to Verizon, Which Will Occur Indirectly as a Result of Verizon's Acquisition of MCI.	Application 05-04-020 (Filed April 21, 2005)

ALTERNATE OPINION APPROVING APPLICATION TO TRANSFER CONTROL

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ALTERNATE OPINION APPROVING APPLICATION TO TRANSFER CONTROL

1. Summary

We approve the application of Verizon Communications Inc. (Verizon) and MCI, Inc. (MCI) (collectively, Applicants) to transfer control of MCI's California utility subsidiaries to Verizon, subject to the conditions set forth in our order.

Contrary to the Assigned Commissioner's Draft Decision in this matter, we find that on the law and on the facts, and as a matter of common sense, Section 854(b) of the Public Utilities Code applies to this extraordinary merger of the state's second largest Incumbent Local Exchange Carrier (ILEC) (Verizon) and one of the country's major Competitive Local Exchange Carrier (CLECs) (MCI). Pursuant to the legislative intent of § 854(b), we calculate net California benefits of the merger of $206 million, half of which ($103 million) must be passed through on behalf of ratepayers of Verizon and MCI.

Like the Assigned Commissioner's Draft Decision, we require as a condition of our approval that the combined company offer stand-alone DSL (digital subscriber line) service to consumers who request such service. We disapprove a proposed settlement between Applicants and certain consumer organizations because terms of that settlement intrude on our ability to set conditions on the merger, but, like the Assigned Commissioner's Decision, we adopt as conditions certain philanthropic terms of that settlement. We impose a number of additional conditions intended to deter anticompetitive effects of the merger.

We find that, subject to Applicants' compliance with the adopted conditions, the merger will produce net benefits for consumers and, because of

our mitigating conditions, will not adversely affect competition for telecommunications service in California. Conversely, if the Applicants decline to implement the conditions set forth in our order, we conclude that the merger does not comply with § 854 and cannot in its present form be approved.

2. Background

This application was filed on April 21, 2005, and amended on May 9, 2005. Applicants seek approval of the transfer of control of MCI's California utility subsidiaries that will occur indirectly as a result of a transaction between holding companies for Verizon and MCI. In Resolution ALJ 176-3152 on May 5, 2005, the Commission preliminarily determined that this is a ratesetting proceeding and that hearings would be necessary.

Protests and responses to the Application were filed on May 25, 2005 by the following parties: the California Association of Competitive Telephone Companies (CALTEL); the Consumer Federation of America; Consumers Union of U.S., Inc.; Disability Rights Advocates (DRA); Latino Issues Forum (LIF); The Greenlining Institute (Greenlining); The Utility Reform Network (TURN); Covad Communications Company (Covad); Cox California Telcom, LLC (Cox); Level 3 Communications, LLC (Level 3); Navigator Telecommunications, LLC (Navigator); the Office of Ratepayer Advocates (ORA); Pac-West Telecomm, Inc. (Pac-West); Qwest Communications Corporation (Qwest); and XO Communications Services, Inc. (XO) (collectively, Intervenors).[1]

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[1] Navigator and XO withdrew from the proceeding in June 2005, and Consumer Federation of America and Consumers Union of U.S., Inc., have not been active in the proceeding since joining in TURN's protest.

Intervenors claim that the merger, in the form proposed by Applicants, will not ensure net benefits to consumers and will adversely affect competition for telecommunications services in California. Certain Intervenors – particularly TURN - categorically oppose the merger under any conditions, claiming that even with mitigating conditions, the merger will still be anticompetitive. They argue that Verizon already has a dominant share of the market in its service area, and that acquisition of MCI will only further expand its market power by eliminating one of its largest competitors. Other Intervenors do not oppose the merger so long as certain conditions are adopted to mitigate perceived adverse impacts. Parties also argue that the proposed merger of SBC Communications Inc. (SBC) and AT&T Corp. (AT&T) must be taken into account in light of the cumulative effect of these two mergers in reducing competition.

Following a prehearing conference on June 21, 2005, a Scoping Memo and Ruling of Assigned Commissioner (Scoping Memo) was issued on June 30, 2005. The Scoping Memo declined to rule immediately on whether §§ 854(b) and (c) applied to the transaction but instructed the Applicants to continue to provide all the information they considered necessary and appropriate to demonstrate compliance with those sections. The Scoping Memo appointed the Assigned Commissioner as the Principal Hearing Officer, with the assigned Administrative Law Judge (ALJ) serving as backup.

On August 15, 16 and 18, 2005, the Commission conducted six public participation hearings in Southern California. On September 19, 2005, the Assigned Commissioner issued a ruling denying motions for evidentiary hearings and finding that §§ 854(b) and (c) do not apply to the proposed merger. In place of hearings, parties were invited to submit verified opening and reply testimony of their witnesses. Testimony of 25 witnesses was received into the record, as were 91 exhibits.

3. The Applicants; the Financial Transaction

The primary corporate entities involved in this transaction are Verizon and MCI.

3.1. Verizon

Verizon is a Delaware corporation.[2] Verizon directly or indirectly owns telephone operating companies that provide telecommunications services on a regulated and unregulated basis in 29 states, Puerto Rico and the District of Columbia, serving 53 million access lines. Although Verizon as a holding company provides no services and is not a regulated telephone company, its local telephone subsidiaries are subject to state public utility regulation. They are subject to regulation by the Federal Communications Commission (FCC) for the services they provide pursuant to federal tariffs and the Federal Communications Act of 1934.

The major California subsidiary, Verizon California Inc., provides regulated telecommunications services, primarily in southern California. Another entity, Verizon West Coast Inc., provides regulated telecommunications services to a small number of customers near the Oregon border. Other Verizon corporate entities provide long distance service throughout California, as well as local private line and other competitive services to customers, including multi-dwelling unit customers. Verizon Wireless provides wireless voice and data

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[2] See Exhibit Verizon/MCI 3 for description.

services in California, across the United States and internationally. Verizon has a national workforce of 210,000 employees, including approximately 18,000 employees in California. Verizon has a strong balance sheet and investment-grade credit rating and is a stable, viable enterprise.

3.2. MCI

MCI also is a Delaware corporation.[3] MCI's subsidiaries provide telecommunications services on a regulated and unregulated basis throughout the United States and in several foreign countries. They provide services to business and government customers, including 75 federal government agencies. MCI is also a significant provider of services to the State of California. Among the enterprise (government and large business) services MCI provides through its subsidiaries are local-to-global business, Internet, and voice services, including Internet Protocol (IP) network technology, Virtual Private Networking, synchronous optical network (SONET) private line, frame relay, ATM and a full range of dedicated, dial and value-added Internet services. MCI's subsidiaries also provide mass market services, including interstate long distance services, intrastate toll services, competitive local exchange services, and other communications services. Some of MCI's subsidiaries are deemed public utilities in the jurisdictions in which they operate. MCI's subsidiaries are also subject to regulation by the FCC with respect to interstate services.

Several of MCI's operating subsidiaries are certificated to provide services in California. MCIMetro Access Transmission Services LLC (MCIMetro) provides local and long distance services in the state. MCI WorldCom

Communications, Inc. (MWC) and MCI WorldCom Network Services, Inc. (MWNS) both provide long-distance services. Teleconnect Long Distance Services and Systems Co. (Telecom*USA) and TTI National, Inc. (TTI) also provide interexchange services. Another subsidiary, SkyTel Corp. d/b/a SkyTel Communications, Inc. (SkyTel) provides wireless messaging services. Collectively, these certificated entities operating in California are referred to as the MCI "California Subsidiaries."[4]

3.3. The Financial Transaction

The proposed transaction involves a merger of Verizon and MCI, the parent holding companies, as a result of which MCI will become a subsidiary of Verizon. The MCI California Subsidiaries will remain subsidiaries of MCI, and the authorizations and licenses currently held by those MCI California Subsidiaries will continue to be held by the respective entities.

The terms of the transaction are set forth in the Agreement and Plan of Merger between Verizon and MCI as approved by the boards of directors of both companies on February 14, 2005 (Agreement) as amended on March 29, 2005.[5] Under the Agreement as amended, MCI's shareholders will receive for each share of MCI common stock (i) Verizon common stock equal to the greater of

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[3] The description of MCI and its business and subsidiaries in based on Ex. Verizon/MCI 4.

[4] Four other subsidiaries were recently decertified in California. These includes: Teleconnect Company; Nationwide Cellular Service, Inc.; Choice Communications, Inc. d/b/a WorldCom Wireless, Inc.' and Nationwide Cellular Services, Inc. d/b/a MCI Wireless, Inc.

[5] The Agreement is identified as Ex. Verizon/MCI 1 and the Amendment as Ex. Verizon/MCI 2.

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 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 transaction.

The Agreement does not call for the merger of any assets, operations, lines, plants, franchises, or permits of the MCI California Subsidiaries with the assets, operations, lines, plants, franchises, or permits of any Verizon entity.[6] To the extent that any such reorganization might be made at a later date, it will be made in the normal course of business and subject to such regulatory approvals as may be required. Similarly, the Agreement does not call for any change in the rates, terms, or conditions for the provision of any communications services provided in California. Applicants acknowledge that to the extent any such changes might be made at a later date, they too will be subject to such regulatory approvals as may be required.

The Applicants state that the transaction will not affect the regulatory authority of the Commission over any of Verizon's regulated subsidiaries or over the MCI California Subsidiaries. Applicants state that Verizon's subsidiaries and the MCI California Subsidiaries will continue to meet all of their obligations and commitments under the Commission's rules, regulations, and orders.

3.4. Reasons for the Proposed Merger

This Application seeks approval of the California portion of a larger national and international merger. This merger comes at a time when the entire telecommunications industry is facing major competitive challenges and new technological options.

For generations, telecommunications services in the U.S. were provided by monopolies subject to traditional state and federal price regulation. This arrangement ended in 1984 with the divestiture of American Telephone and

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[6] Ex. Verizon/MCI 3, ¶¶ 14-15.

Telegraph Company (AT&T, also known as the "Bell System") through an antitrust consent decree between the United States Department of Justice (DOJ) and AT&T. The consent decree divested AT&T of its local telephone operations from which several independent "Regional Bell Operating Companies" (RBOCs) were created. The 1984 divestiture was required to address various ways in which the former Bell System impeded competition, particularly through its exercise of bottleneck monopoly control over the critical "last mile" linking individual customer premises to the public switched network.

Concurrent with the divestiture, state and federal regulators began initiatives to open the telecommunications marketplace to competition. Competitive barriers to entry were first lifted in the long distance market for carriers other than the incumbent local exchange carriers. With the passage of the 1996 Telecommunications Act, further progress was made toward opening local exchange markets to competition. More recently the long distance market has been opened to the Incumbent Local Exchange Carriers (ILECs).

With opening of more markets to competition, there has been continuing evolution in the industry structure, including the introduction of new technologies to compete with the traditional telephone service. In response to these regulatory, technological, and economic challenges, various carriers, including the traditional RBOCs, have progressively consolidated their operations through mergers and acquisitions in recent years.

The proposed Verizon/MCI merger marks a significant crossroads in the trend toward consolidation within the industry. We fully recognize that the regulatory, economic, and technological climate in which this merger arises is very different from that of the 1984 divestiture. Nonetheless, fundamental concerns over this transaction's effects on competition and the public interest remain paramount today. Given the far-reaching scope and implications of this merger and the concurrent SBC/AT&T merger for the industry and the public, we approach our review of this merger with great care.

Verizon's stated purpose in the acquisition of MCI is to combine the complementary strengths of the two companies to enable the merged company to compete more effectively. MCI has a significant base of enterprise customers and an Internet Protocol-based national and international network, while Verzion lacks a substantial Internet backbone or interLATA transmission facilities. On the other hand, Verizon's strength is in the provision of services to residential and small business customers and its substantial investment in the provision of wireless services, which MCI does not provide. Applicants state that the combined company will be in a strong financial position to invest in the existing IP network at a lower cost of capital than MCI could obtain on its own, in order to increase network capacity, extend network reach, and add new capabilities.

By combining their respective strengths, Applicants claim that the merger will enable the combined company to become a stronger competitor and to serve a wider range of customers across all segments of the telecommunications marketplace beyond just the traditional Verizon California territory.

MCI likewise views the merger as an appropriate response to developments that have challenged its competitive stance in certain markets. In the mass market, MCI provides local and long distance services, using leased facilities to provide the local components rather than through its own facilities. The evidence is uncontroverted that MCI's mass market business is in decline, due to increasing competition in its core long distance business as well as recent changes in regulation affecting both the price at which it leases local facilities and its marketing efforts. MCI's bundled service offering has faced increasing competition, both from wireless providers' "all distance" packages, the entry of RBOCs into the long distance market, and competition from non-traditional providers. Federal regulatory decisions in the last two years have removed the availability of the unbundled network element UNE-P platform at regulated TELRIC-based rates, leading MCI to enter into commercial agreements with ILECs at higher rates. MCI's recent commercial contracts with SBC and Verizon raise commercial end-to-end local service substantially above TELRIC rates and provide for rate increases each year.

With the elimination of UNE-P as a competitive resource, MCI has sharply curtailed marketing local service to new mass market customers. MCI chose to consider new options, leading ultimately to the merger that is the subject of the application before us.

4. Standard for Review

The Applicants must obtain authorization from this Commission for approval of the proposed acquisition of MCI by Verizon in accordance with the requirements of Pub. Util. Code § 854, which sets forth the standard for review of the transaction. While all parties agree on the general statutory applicability of § 854, they disagree on which subsections of the statute apply, and how extensive the scope of review should be. Section 854(a) provides that no person or corporation shall merge, acquire, or control either directly or indirectly, any public utility organized and doing business in this state without first obtaining authorization from this Commission. Sections 854(b) and (c) establish more comprehensive requirements for the merger of very large entities, including a requirement that financial benefits of the merger in California be shared on at least a 50-50 basis with customers. As discussed below, we conclude that the standard of review in this Application must take into account all provisions of § 854.

Applicants bear the burden of proof and are required to prove by a preponderance of evidence that the proposed merger meets the requirements warranting approval pursuant to § 854.

In particular, we must find the proposed merger provides short-term and long-term economic benefits to ratepayers, does not adversely affect competition, and is in the public interest. (§§ 854(b) and (c).) To the extent that we find Applicants have not met this burden, we consider mitigating measures that are warranted in order to reduce anticompetitive effects.

4.1. Applicability of §§ 854(b) and (c)

4.1.1. Parties' Positions

Applicants acknowledge that the Commission has authority over approval of the transaction pursuant to § 854(a), but deny that § 854(b) applies. Applicants argue that § 854(b) only applies to "transactions in which a regulated utility is itself a direct party to the transaction." (Application, at 14.) This transaction, however, is designed as a merger between corporate holding companies. Because the merger agreement does not define any California utility entity as a party, Applicants claim that § 854(b) by its own terms does not apply.

Section § 854(b) requires as a condition for Commission approval that a transaction:

1. Provides short-term and long-term economic benefits to ratepayers.

2. Equitably allocates, where the commission has ratemaking authority, the total short-term and long-term forecasted economic benefits, as determined by the commission, of the proposed merger, acquisition, or control, between shareholders and ratepayers. Ratepayers shall receive not less than 50 percent of those benefits.
3. Not adversely affect competition.[7]

Section 854(b) applies where any utility that is a party to the transaction has gross annual California revenues exceeding $500 million. Verizon California and the various MCI subsidiaries have gross annual California revenues well in excess of $500 million.

In support of the claim that § 854(b) does not apply, Applicants argue that the term "utilities" referenced in § 854 (b) differs from the term "entities" that is used in § 854 (c).[8] Applicants construe the use of different terms (i.e.,"utility" in § 854(b) versus "entity" in § 854(c)) as a distinction made by the Legislature to indicate different categories of applicability. Applicants thus would have us infer that § 854(b) only applies to transactions in which a utility (rather than a holding company of utilities) is named as a direct party to the transaction.

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[7] In making this finding, the Commission shall request an advisory opinion from the Attorney General regarding whether competition will be adversely affected and what mitigation measures could be adopted to avoid this result. While the Assigned Commissioner in this proceeding found that § 854(b) did not apply, an advisory opinion from the Attorney General was nevertheless requested.

[8] The requirements of § 854(c) apply to any *entity* that is a party to the transaction with gross annual California revenues exceeding $500 million, and require the Commission to consider each of the criteria listed in paragraphs (1) through (8) of that subsection, and to find, on balance, that the proposal is in the public interest..

By contrast, Applicants construe § 854(c) as applying to a broader category of transactions. Yet, even though Applicants acknowledge that § 854(c) technically applies here, they argue that the Commission should exercise its discretion to exempt this transaction from the requirements of that subsection. Whether that is done or not, Applicants claim that this transaction satisfies the public interest requirements of § 854(c).

All active parties in the proceeding other than Applicants take the position that both § 854(b) and § 854(c) apply to this transaction, and that the Commission must make findings consistent with those code sections in order to approve the merger. They argue that Applicants' legal interpretation seeking to limit the applicability of the statute is invalid and fails to acknowledge the importance of this transaction. Intervenors challenge Applicants' attempts to justify an exemption from §§ 854(b) and (c) based on comparison with other merger cases, claiming that such cases did not involve a dominant carrier and are not comparable to this proceeding.

4.1.2. Discussion

We conclude that §§ 854(b) and (c) apply to this transaction. Sections 854(b) and (c) together form "the primary statute governing mergers involving California's large energy and telecommunication utilities."[9] This transaction involves both the second largest ILEC in California and one of the largest CLEC/NonDominant Interexchange Carriers in California. The two major transactions creating what is now Verizon were also reviewed under

[9] *SCEcorp*,, 40 CPUC2d at 171.

§§ 854(b) and (c).[10] Likewise, SBC's acquisition of Pacific Telesis was reviewed under §§ 854(b) and (c). Indeed, if § 854(b) does *not* apply to a merger transaction the size of this one, it is difficult to imagine under what circumstances this legislative mandate could ever apply.

We reject Applicants' argument that special significance attaches to the use of the words "utilities" versus "entities" in assessing the applicability of §§ 854(b) and (c).[11] In the SBC/Telesis merger proceeding, we rejected the argument that § 854(b) does not apply merely because the transaction was defined as a transfer of control between holding companies as the "parties." As explained in D.97-03-067, the word "party" as used in § 854(b) must be read to include those California entities that are "involve[d]" in the transaction even if the deal is "technically structured" so only the parent-level holding companies participate in the merger transaction.[12] Even though the SBC/Telesis merger nominally involved two holding companies, we still held that the California operating company, "Pacific[,] is a party within the meaning of § 854." We refused to base our decision on a mere technical interpretation of the words "utility" and "entity" because such an approach looked too much to the mere form of the statute and the transaction.[13]

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[10] In *GTE Corporation* (1991) 39 CPUC2d 480 (D. 91-03-022), the Commission reviewed the GTE/Contel merger under Sections 854 (b) and (c). Also, in *GTE and Bell Atlantic* (2000) Cal. PUC LEXIS 398 (D.00-03-021), the Commission reviewed the merger leading to the formation of Verizon under §§ 854(b) and (c).

[11] *Pacific Telesis Group* (1997) 71 CPUC2d 351 (D.97-03-067).

[12] *Id.*, at 365.

[13] *Id.*, at 364.

The SBC/Telesis decision followed California Supreme Court precedent that a utility cannot "through corporate instrumentalities obtain" a result that is different from the result "the utility would be entitled to absent the separate corporate enterprises." (*Pacific Telesis Group, supra,* 71 CPUC2d at 365.)

It would be equally improper to elevate form over substance here by exempting the Verizon/MCI transaction from §854(b) review. Even though the transaction is defined as involving only holding companies, the substance of the transaction will have a significant impact on California public utilities and their customers. The Commission has broad statutory powers to ensure that ratepayers are not deprived of the benefit of transactions where the utility would have been directly involved, but for the holding company structure. We view the utility enterprise as a whole without regard to the separate corporate entities that in effect are different departments of one business enterprise (*General Telephone Company v. Public Utilities Commission* (1983) 34 Cal.3d 817, 826).

Designing the transaction around a holding company structure provides no reason to reduce the review that the Commission gives to this transaction. Ratepayers can be exposed to even more risk under a holding company structure, as we have previously noted:

> The regulator has no choice but to view costs assigned to utility subsidiaries by holding companies very skeptically, especially where the corporate family is in diversified lines of business, because there is always the motive and temptation to have as many costs as possible born by the utility's monopoly operation. (*Re Pacific Bell* (1986) 20 CPUC2d 237, 274-275; D.86-01-026.)

We reject Applicants' argument that the reasoning applied in the SBC/Telesis merger concerning the applicability of §§ 854(b) and (c) does not apply to this transaction because the firm being acquired here is not a dominant carrier. We recognize that the SBC/Telesis merger involved the acquisition of an ILEC. The fact remains that this transaction involves an acquisition by Verizon that will have an impact on the operations of Verizon California, as well as the competitive environment in which the ILEC operates.

Applicants are incorrect in claiming that the Commission does not look to the status of an acquiring firm in assessing the applicability of § 854(b). One of the main considerations in *MCI Communications Corp. and British Telecom* (1997) 72 CPUC2d 656 (D.97-05-092) was the nature of the acquiring firm's business. The Commission relied heavily on the fact that British Telecom (BT), the acquiring firm, "operates exclusively in the United Kingdom and does not propose physically to enter California markets."[14] In addition, the analysis called for in § 854(b) looks to the combined effect of the transaction participants. Transaction benefits are often derived from the combination of two firms. Anti-competitive effects also arise from the combination of two firms. We reject Applicants' argument that the Commission should only focus on the acquired firm.

Thus, the common element in both the Telesis merger and this transaction is a business combination in which the operations of one of the largest California ILECs are implicated. While the specific form of business combination is different, the principle remains relevant that form should not be placed over substance in assessing the applicability of §§ 854(b) or (c).

Even though Applicants claim that the Verizon California local network is not impacted, their testimony nonetheless indicates that customers of the ILEC

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[14] *MCI Communications Corp. and British Telecom* (1997) 72 CPUC2d. 656, 664.

will be affected by the merger. For example, Applicants claim that MCI services will be delivered to Verizon customers or will use MCI facilities to deliver services (*e.g.*, MCI Internet backbone). MCI's role in the enterprise market is emphasized by Applicants as a primary motivation for entering into the merger. Applicants acknowledge that some of the services provided to enterprise customers in California will be subject to the Commission's ratemaking authority. Applicants claim that the combined company will have enhanced resources, expertise and incentive to adapt the sophisticated products that MCI has developed for its enterprise customers to the needs of Verizon California's small and medium businesses and consumers.

Both the SBC/Telesis merger and this transaction involve significant changes to the competitive environment within California that warrant review under §§ 854(b) and (c). Moreover, in the SBC/Telesis merger, the two merging parties did not compete against each other in California. By contrast, Verizon and MCI compete against each other within California. The competitive significance of two major competitors merging should be reviewed at least as carefully as the SBC/Telesis merger where only one California competitor was involved.

4.2. Exemption Under § 853(b)

4.2.1. Parties' Positions

Applicants argue that even if the Commission were to determine that §§ 854(b) and (c) may be applied here, it is within the Commission's discretion to grant an exemption from those requirements. The Commission has discretion to grant an exemption pursuant to § 853(b), which provides in relevant part:

> The commission may. . . exempt any public utility. . . from this article [including Sections 854(b) and (c)] if it finds that the

> application thereof with respect to the public utility . . . is not necessary in the public interest."

Intervenors argue that, in view of the record on the impacts of this merger, there cannot logically be a finding that applying §§ 854(b) and (c) is "not necessary in the public interest." Applicants respond that the Commission has exempted other merger transactions involving NDIEC and CLEC assets. Applicants state that this merger is similar to previous mergers involving the acquisition of a nondominant carrier. Opposing parties disagree, arguing that such a characterization overlooks the major competitive significance of this merger and ignores critical differences that distinguish this merger from others in which §§ 854(b) and (c) exemptions were granted. Opposing parties note that in past merger cases where §§ 854(b) and (c) were not applied, the transactions exclusively involved NDIEC and CLEC assets where the surviving utility was nondominant. By contrast, this merger involves the assets and operations of the second largest ILEC in California. Intervenors argue that, given the involvement of ILEC operations, the need for the safeguards provided by §§ 854(b) and (c) figures more significantly here.

4.2.1.1. Discussion

Given the distinctive historic proportions and long-term implications for competition in this matter, we conclude that this merger is not analogous to previous mergers that were routine in nature, or that exclusively involved NDIEC and CLEC assets. The exemptions granted in those past mergers provide no comparable basis for §§ 854(b) and (c) exemptions here.

This merger has greater long-term implications than nondominant carrier mergers in view of the concurrent merger contemplated between SBC and AT&T. The post-merger environment anticipates elimination of not just one but both of the two largest competitors of Verizon in California. None of the merger precedents cited by Applicants contemplated such a fundamental and historic shift in the competitive make-up of the industry.

Past telecommunications transactions involving utilities exempted from review by virtue of § 853(b) presented factors that are not present here. They did not involve an ILEC, they often did not involve more than one California operating utility. For example, the proposed BT/MCI transaction was a foreign takeover where MCI would have become the U.S. operating arm of BT. The WorldCom case was a bankruptcy reorganization where MCI succeeded to the business of the discredited WorldCom. The most comparable precedents are the SBC/Telesis and GTE/Bell Atlantic mergers, both of which received scrutiny under §§ 854(b) and (c). We find that precedent supports the application of §§ 854(b) and (c) to the proposed Verizon/MCI merger.

5. Net Benefits Showing

Section §854 (b)(2) requires that, in order to warrant approval, merger transactions must produce both "short-term" and "long-term" economic benefits, and it requires the Commission to equitably allocate, where it has ratemaking authority, the total of such forecasted benefits between shareholders and ratepayers, with ratepayers receiving no loss than 50% of those benefits. To the extent that applicable benefits of the merger can be identified, we find that a 50% sharing of those savings between ratepayers and investors is reasonable and consistent with the requirements of § 854(b)(2).

5.1. Qualitative Benefits

5.1.1. Parties' Positions

Applicants claim that there are no savings from the merger specifically attributable to California retail customers, and that there should be no surcredits or other pass-through of savings to retail customers as a condition of approving the merger. Applicants claim that, to the extent that California retail customers realize any benefits from the merger, such benefits will be in the form of improvements in the range and quality of service, including provisioning of voice, data, and video services.

ORA argues that Applicants' claims of mere qualitative, or "soft," benefits are not the "economic benefits" required by § 854(b). ORA witness Selwyn testified that service quality improvements would not "constitute an 'economic benefit' for California ratepayers" unless "existing service quality [from Applicants]. . . in California today is less than satisfactory."[15] Applicants have not contended that existing service quality is unsatisfactory, nor have they provided specific details about how the merger would improve service quality in California.

5.1.2. Discussion

We agree that "soft" benefits, as described by Applicants, do not satisfy the net benefits requirements of § 854(b). Most of Applicants' highlighted advantages of the merger, such as network integration and the ability to attract a larger number of large global customers, are essentially shareholder benefits. Such "soft" benefits would impact consumers only to the extent they manage to "find [their] way into consumer" segments of the market via a "ripple down" effect.[16]

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[15] Ex. ORA 1 (Selwyn).

[16] Ex. Verizon/MCI 25 (Smith/McCallion) at 2 ("The Applicants will be subject to competitive forces that will force them to flow through an equitable share of the synergies to customers.")

Applicants' witnesses are vague about whether, or when, any consumer benefits might be realized. They testified that the intention of Applicants is to develop new products and apply them to the enterprise market, with the effect that at least some of these products will apply to the mass market as well. They further testified that details about new projects could not be stated at this time because Applicants do not know specifically what the new projects will be.

ORA witness Selwyn challenges Applicants claims' of innovation from the merger, arguing that competition, not the scale of operations, is the driver of innovation. Selwyn stated that firms with few or no rivals have little incentive to bring new products to market. He argued that academic literature corroborates that competition drives innovation.[17] TURN and ORA maintain that the proposed merger is risky for ratepayers. Selwyn testified that the merger could lead to an overall increase in the rates consumers pay for services because of the initial costs of consolidation, even if in the aggregate the merger produces positive economic benefits for Applicants.

5.2. Applicants' Calculation of Savings

Regarding net customer benefits expected from the merger, Applicants sponsored the testimony of Stephen E. Smith, Verizon group vice president for business development of domestic telecommunications. Smith is responsible for developing estimates of the synergies resulting from the proposed merger.

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[17]. *See, e.g.,* Wendy Carlin, *et al., A Minimum of Rivalry: Evidence from Transition Economies on the Importance of Competition for Innovation and Growth*, Contributions to Economic Analysis & Policy, Vol. 3, Number 1, 2004, Article 17, cited in Ex. 126C, ORA/Selwyn.

Although Applicants dispute that § 854 (b) applies to the Verizon/MCI acquisition, in compliance with the Assigned Commissioner's Ruling they produced a calculation of certain merger-related savings that could theoretically be shared with California customers. These savings are generally referred to as "synergies." To calculate a California share of synergies, Applicants start with the base figure for merger-related savings derived from their National Synergy Model. This national model was created during the "due diligence" process prior to Verizon's signing the merger agreement with MCI to assist senior management and the board of directors in evaluating the transaction, and to assist in determining the price to pay for MCI.

The National Synergy Model estimates that the transaction will generate $7.3 billion of present value arising from new revenues and expense and capital savings, net of costs to achieve those benefits and net of related taxes. The Applicants attribute almost 50 percent of these synergies to network operations and IT functions, with substantial synergies from procurement cost savings and increased revenue opportunities. Applicants also expect synergies from the reduction in third party network expenses due to moving network traffic onto MCI's network, elimination of overlap between Verizon and MCI staff relating to national networks, enterprise sales and support, and headquarter operations (*e.g.*, finance, accounting, human resources, and legal).

Applicants calculated operating synergies in California by deducting costs necessary to achieve those synergies, allocating the remaining net synergies to Verizon California, excluding MCI synergies and excluding synergies that Verizon will realize in operations where the Commission does not exercise direct ratemaking authority. The Applicants then discounted the forecasted synergies to present value to compute economic benefits to be $6.6 million (with a $3.3

million share going to ratepayers). The $6.6 million estimate represents about one-tenth of 1% of the total corporate synergies.

5.3. ORA and TURN Calculations

ORA and TURN performed their own analyses of synergy savings attributable to California consumers, and presented testimony concluding that Applicants' calculation of the total merger synergies allocated to California consumers was significantly understated. As a basis for their calculations, ORA and TURN relied on the Applicants' synergy model as a starting point, and made adjustments to the Applicants' figures. On a net present value basis, taking into account adjustments for the alleged deficiencies, ORA estimates of the correct amount of synergies attributable to California is $206 million[18], while TURN calculates the amount as $365.7 million.[19] ORA and TURN propose applying 50% of these synergy savings to ratepayers pursuant to § 854(b).

The ORA and TURN figures differ from Applicants' estimate by a considerable amount due to several adjustments not contemplated by Applicants. In particular, ORA and TURN (1) include revenue synergies as well as expense synergies; (2) include benefits over the full long term; (3) include the full range of national synergies (and costs) for both Verizon and MCI, with the exception of categories of costs not attributable to the merger; (4) allocate transaction costs across synergy categories; (5) include an estimate of the savings due to a reduction in MCI's cost of capital; (6) correct a minor error in severance

[18] Selwyn Testimony, Ex. ORA 1.

[19] Murray/Kientzle Testimony, Ex. TURN 1.

costs for corporate headcount reductions; (7) assume a different discount rate, and (8) apply different allocation factors per type of major market.

Applicants take issue with Intervenors' criticism of their calculation of synergies, characterizing it as "second guessing" the professional judgment of managers. We disagree with this characterization. Opposing parties are entitled to examine all relevant documentation in an effort to validate any part of Applicants' modeling methodology. To the extent that the development of national synergies estimates were developed through due diligence and the "best business judgment" of Verizon senior management, parties should be able to validate that due diligence and the methodology employed in developing specific estimates.

5.4. Short-Term and Long-Term Benefits

5.4.1. Parties' Positions

One of the largest factors accounting for the difference between the Applicants and ORA/TURN in measuring benefits subject to § 854(b) ratepayer sharing relates to the time period over which synergies forecasts are recognized. For purposes of their calculation of $6.6 million in California-specific synergies subject to ratepayer sharing, Applicants limited the time horizon to a four-year period. Applicants recognize no distinction in their calculation between the "short term" and the "long term" (pursuant to § 854(b)) for purposes of allocating benefits to ratepayers.

Section 854(b), however, requires calculation of both "short-term" and "long-term" consumer benefits from the merger. The statute does not provide a specific definition of what constitutes the short term versus the long term. TURN argues that the projected costs of implementing the merger are likely to result in little or no net benefit for customers in the short term, representing the initial years of the merger.

While Applicants have calculated the California-specific synergy benefits by limiting the forecast time horizon to four years, the National Synergy Model forecasts additional merger synergies through the year 2013 (or eight years), and also includes an additional terminal value for synergies anticipated into perpetuity. The National Synergy Model estimates were used as a basis to make representations to the financial community.

The estimated costs to achieve the merger occur in the initial years after the transaction, while offsetting savings are realized over a longer period. Using a four-year period for measuring California ratepayer synergies implies that most of the initial merger costs are incorporated in the estimate, while only a small percentage of the offsetting savings forecasted by the National Synergy Model is included. ORA and TURN argue that Applicants provide no valid reason to limit the California-specific forecast of benefits to a shorter period than the one used by Applicants to calculate merger benefits to justify the Federal Communications Commission (FCC) approval of the transaction.[20] ORA argues that an economic definition of "long term" should refer to the period of time after merger implementation costs were incurred, allowing all permanent synergy and other efficiency gains to be included in the calculation of merger benefits. Applicants claim that if the Commission uses the same definition of long term used for Applicants' forecasts presented to the financial community,

[20] Murray/Kientzle Reply Testimony, Ex. TURN 1.

there will be an inordinate risk upon the companies' financial operations and shareholders.

ORA witness Selwyn testified that the merger poses virtually no investor risk, while ratepayers will confront a substantial risk that the merger will create a far less competitive market overall, with the likelihood that California ratepayers generally will see price increases. ORA argues that the Commission should not reduce ratepayer benefits to account for alleged shareholder risk by cutting off the calculation at four years and ignoring subsequent years projected benefits. Accordingly, ORA calculated the synergies attributable to California over the same time frame used by SBC for its shareholder and investor synergy disclosures.

5.4.1.1. Discussion

Section 854(b)(2) *requires* that California ratepayers receive a minimum of 50% of the total short-term and long-term forecasted economic benefits of the merger, where the Commission has ratemaking authority. In reviewing the available material produced for this proposed merger, ORA and TURN allege deficiencies in the Applicants' California synergy calculation, and have corrected these to reach similar estimates of the amount of synergies attributable to California. ORA calculates that amount at $206 million, and thus recommends an allocation to ratepayers of 50% of this amount.

Although Applicants propose a four-year "long-term" definition for determining the synergies attributable to California, the national synergy figure they presented to investors and shareholders, and which was reported in their 8-K filing with the SEC, calculates merger synergies for eight years and into perpetuity. Using a four-year definition of long term ensures that most of the expected one-time merger costs are incorporated, while only a smaller percentage of expected merger savings is included. All of the merger costs-to-achieve occur in the first several years after the transaction, while benefits increase over time. As a result, the costs-to-achieve become a larger proportion of the total synergies over the first four years than when considered relative to total synergies as disclosed to investors, which creates an unjustified disparity in the manner in which costs-to-achieve and the resulting synergy gains are allocated to ratepayers. California ratepayers will have to fund the costs-to-achieve while enjoying few of the synergies the financial community expects shareholders to realize. Applicants have provided no viable basis for presuming that synergy benefits associated with California intrastate services will end any sooner for ratepayers than for shareholders. Nor have they provided a policy reason for the Commission to limit the California-specific forecast of benefits to a shorter period than the one used by Applicants to calculate merger benefits used to justify the FCC and shareholder approval of the transaction.

We conclude that all MCI and Verizon California activities "where the Commission has ratemaking authority" (whether that authority is exercised or not) should form the basis for the § 845(b)(2) allocation of benefits to California ratepayers. Applicants understate the California-specific synergies by creating a factor that considers only Verizon California synergies, ignoring the intrastate operations of MCI activities in California, which form the bulk of the merger synergies related to Applicants' combined post-merger California operations.

Applicants justify their approach as being consistent with the approach for evaluating synergies adopted by the Commission in the GTE/Bell Atlantic merger. However, prior to that merger, Bell Atlantic did not have any meaningful operations in California, so there were no Bell Atlantic "California synergies." This was also the case with the SBC/Pacific Telesis merger, where SBC had no California operations going in, and neither of those merger proceedings presented the Commission with the question as to how to identify California-specific merger benefits when both the acquired and the acquiring company have substantial assets and operations in California and where they compete with one another in the California market. In both of those proceedings, it made sense to limit the analysis of California specific synergies solely to the operating company being acquired, precisely because the company being acquired was the only entity with significant California-regulated operations. Neither of those decisions serves as precedent for excluding MCI's California operations from the California-specific merger synergies of a merger between Verizon and MCI.

Section 854(b)(2) does not suggest that one company in a merger should be excluded in determining economic benefits. The subsection clearly requires the Commission to "[e]quitably allocate[], where the Commission has ratemaking authority, the *total* short-term and long-term forecasted economic benefits ... of the proposed merger, acquisition, or control, between shareholders and ratepayers." The only limitations are that the Commission must have ratemaking authority, and that the allocation must assign a minimum of 50% of the economic benefits with ratepayers. It is clear that there is a duty to include all forecasted economic benefits, and not just those to be realized only within the first four years and only by Verizon California.

For these reasons, we conclude that MCI's California intrastate operations should be included in calculating the California synergies allocated to California ratepayers. ORA presented synergy figures including both Verizon and MCI California intrastate operations synergies. This adjustment results in California specific synergies of $206 million if taken in perpetuity as assumed by Joint Applicants.

This Commission must evaluate the proposed transaction in light of the risk it entails. The soft benefits claimed by Joint Applicants are at best suppositions and speculations. They have not been economically quantified and have not been compared to the risks this transaction poses to ratepayers. Applicants do not give any firm assurances that these benefits will actually arise, let alone flow to ratepayers; they only suggest that the soft benefits might find their way to ratepayers at an unspecified time in the future.

Section 854(b) requires that ratepayers receive benefits over both the short-term and long- term, but does not specifically define a duration for either period. In prior decisions analyzing § 854(b), we have held that the definition of long-term may vary with the circumstances of each individual case. We conclude that, in this case, ORA and TURN have made the stronger showing that the merger portends risk to ratepayers that must be ameliorated to some extent by an equitable sharing of merger synergies. We further conclude that Applicants have not demonstrated by a preponderance of evidence that a sharing of one-tenth of 1% of their anticipated total synergies will adequately compensate Verizon and MCI ratepayers for the risks they are about to undertake. We will adopt ORA's estimate of California synergies that must be shared on a 50% basis with ratepayers. This figure is a reasonable and well-supported estimate of the value of merger synergies attributable to California, and these benefits will offset the risks to which this proposed transaction may subject ratepayers . We note also that the ORA calculation is somewhat less than but roughly equivalent to TURN's synergy estimate for the period between eight and nine years after the merger takes place. In this case, we believe that a period of approximately eight years is a fair assessment of the "long-term" benefits of this merger.

We note that Applicants have entered into a settlement with Greenlining and LIF in which stipulated amounts of philanthropic contributions would be designated as the sole § 854(b) benefits to be adopted in this proceeding.[21] Yet, the settlement does not purport to represent any quantitative analysis of actual synergies that would actually be realized through the merger. For reasons discussed below, we decline to limit § 854(b) benefits solely to those identified in the settlement.

In order to find that this merger is in compliance with § 854(b), we require that 50% of the $206 million net synergies be shared with California consumers, resulting in an allocation of $103 million on a discounted net present value basis. We address the allocation of these consumer benefits in the sections that follow.

5.4.1.2. Ratemaking Authority

Applicants argue that regardless of whatever level of merger savings may be attributable to California utility operations, the Commission should not impose a mandatory sharing of such benefits because the Commission does not have "ratemaking authority." Since MCI and its affiliates are classified as CLECs and NDIECs, they are not subject to cost-of-service rate regulation. Accordingly, Applicants argue that because the utilities being acquired are not subject to rate regulation, the merger transaction, itself, is not subject to the purview of § 854(b)(2). Applicants assert that the legislative history of Assembly Bill 119 of

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[21] Section 1.2.3 of the proposed settlement provides: "in the event the Commission were to determine that Section 854(b) obligations apply to the Application, the Parties will support a Commission determination that the terms and conditions of this Agreement shall be considered as a means of allocating benefits under Section 854(b)(2). Greenling and LIF will advocate that this Agreement constitutes satisfaction of Section 854 requirements."

the 1995-1996 legislative session (AB 119) demonstrates that NDIECs and CLECs are exempt from § 854(b)(2)'s requirements.

We disagree. The language of the statute does not specifically refer to NDIECs and CLECs. California courts rightfully express "skepticism about looking beyond the statutory language when trying to discern the legislature's meaning." (*Pacific Bell v. Public Utilities Com*. (2000) 79 Cal.App.4th 269, 280.) The fact that the regulatory status of a company is relevant to whether or not an exemption should be granted does not show that the statute automatically excludes NDIECs and CLECs from §§ 854(b) and (c) review. In any event, this transaction involves the acquisition—and removal from the market—of a very significant NDIEC and CLEC. It also involves an acquisition by California's second largest ILEC. Thus, this transaction is not analogous to past proceedings where NDIECs and CLECs continued to participate in the market after the merger closed, and where no dominant ILEC was involved in the acquisition.

5.4.1.3. Implementing Pass-Through

Because there were no hearings in this case, and because an Assigned Commissioner's Ruling held (erroneously, we believe) that § 854(b) did not apply, we have an incomplete record as to how identified net benefits should be passed through to consumers.

ORA and TURN did not formulate specific proposals concerning how the net benefits should be allocated among different groups of consumers. ORA and TURN do agree, however, that merger savings to be shared with ratepayers need not all necessarily flow through as rate surcredits. ORA witness Selwyn characterized ratepayer benefits as "currency" to "spend" on various mitigation measures. ORA believes that proposals for the uses of shared benefits should be subject to examination and further comments. ORA and TURN propose that the specific allocation of the net benefits among different consumer groups and interests be addressed in a separate phase of this proceeding.

Various other parties and individuals at the public participation hearings have urged that any net benefits be earmarked for designated purposes, such as funding programs to help bridge the "digital divide" experienced by various underserved elements of the communities in which Verizon provides service. In this regard, we are also separately adopting certain conditions pursuant to § 854(c) relating to philanthropy commitments by Verizon, as discussed in a subsequent part of this decision.

In order to provide a proper basis upon which to determine how net consumer benefits from the merger should be distributed, we will adopt the ORA/TURN proposal to take further comments on this issue. Before determining the specific allocation of net benefits adopted herein, we solicit comments to be filed 20 calendar days following the effective date of this decision concerning proposals for the specific allocation of the net benefits among consumer groups and/or other programs for the benefit of consumers. Following receipt and review of comments, we shall proceed with further steps to implement the distribution of net benefits to consumers as adopted in this decision.

6. Competitive Impact Under § 854(b)(3)

Section 854(b)(3) requires the Commission to make a finding that the proposed merger does "[n]ot adversely affect competition." In assessing the impact of the proposed merger upon competition, the Commission should be informed, but not constrained, by federal antitrust laws.[22] Thus, the Commission should consider the proposed merger in light of the Horizontal Merger Guidelines of the U.S. Department of Justice (DOJ) and the Federal Trade Commission (FTC), and apply the Hirfindahl-Hirschman Index (HHI) of market concentration. With its first-hand familiarity with the markets at issue here, however, the Commission has unique knowledge to bring an examination of the effect the proposed merger will have on the development of local competition in California.

Applicants assert that this merger should be evaluated using a "forward-looking" approach to competition analysis, taking into account the rapid expansion of wireless cellphones and other intermodal forms of telecommunications. ORA witness Selwyn and TURN witness Murray conducted a more traditional analysis of market shares. These analyses show a highly concentrated market for residential local and long distance service, and these witnesses conclude that the proposed transaction will have significant adverse effect on competition.[23] Applicants criticize Intervenors' analysis, claiming that, in this case, traditional competition analysis should not apply.

We agree with the Opinion of the Attorney General (AG) on this subject. The AG Opinion states that "[t]he Guidelines require that changes in the Herfindahl index be calculated as a 'starting point' in all merger reviews."[24] Applicants' witness Rubinfeld apparently agrees, as he notes, "HHIs can be

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[22] *Re Pacific Telesis Group* (1997) D.97-07-037.

[23] Ex. TURN 1 (Murray/Kientzle) at 228; Ex ORA 1 (Selwyn) at Table 2.

[24] AG Opinion at 10 (citing Merger Guidelines at § 2.0).

useful as a screen to determine what mergers might merit further investigation, and as an indicator of market power."[25]

Although Applicants' testimony describes competitive pressures that the two companies believe they are facing, especially with respect to intermodal competition, Applicants have not presented any empirical analyses demonstrating the extent of the competition that the merged company would actually face. Both ORA witness Selwyn and TURN witness Murray have presented empirical analyses in their testimony, applying the DOJ and FTC's *1992 Horizontal Merger Guidelines*, and the April 8, 1997 revisions (Merger Guidelines).

Selwyn testified that these analyses show two things. First, many telecommunications markets are already highly concentrated, even if intermodal competition is included. Selwyn comments:

> Without question, the various product/service markets in which both merger partners operate – basic local exchange service, long distance for residential and small business customers and enterprise customers – all are "highly concentrated" as the term is defined by the *Guidelines*. That is, all have HHIs of at least 1800 within the Verizon region prior to the merger.[26]

Second, according to these analyses, this transaction will increase Verizon's market power in several markets. Murray calculates that the local residential wireline market will increase by over 500 points, and Selwyn calculates that the HHI of the long distance market will increase by more than

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[25] Ex. Verizon/MCI 22 (Rubinfeld) at para. 73.

[26] Ex. ORA 1 (Selwyn) at 88.

1300 points. The Merger Guidelines consider an increase of 50 points to indicate the likelihood of increased market power, or an increased ability to exercise market power, where the post-merger HHI is greater than 1800.[27]

6.1. Loss of MCI as a Competitor

Applicants state that MCI will not be a significant mass market competitor in the future regardless of the outcome of the merger because MCI's mass market share is declining, as evidenced by the 37% wireline revenues decline from 2001-2004. In addition, Verizon has experienced a decline in access services consistent with the reported decrease in wireline long distance. Applicants argue that since MCI is withdrawing from the mass market, it cannot be presumed that MCI will exist in the future as a competitor.

Cox and other Intervenors contend that MCI would have remained an independent player among competitive service providers, well equipped to negotiate and arbitrate interconnection terms, drive regulatory and technology changes, and serve as a model or an ally for other competitors. They state that "MCI remains one of Verizon's largest competitors, with millions of residential access lines, many of which are in California. MCI is also a direct competitor of Verizon in the enterprise business market."[28]

CALTEL and Cox assert that in addition to the loss of MCI as a market competitor, there is concern about the loss of a major voice for competition in the regulatory process. Existing mechanisms to foster competition depend on tension between competitive and monopoly forces. The loss of MCI's and

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[27] *Merger Guidelines* at 1.51(c).

[28] ORA, Selwyn, p. x.

AT&T's abilities to negotiate reasonable interconnection agreements pits the limited resources of smaller competitors against the abilities of the incumbents to delay interconnection negotiations. Cox states that MCI's technical, operational, financial and legal expertise and resources have provided a measure of balance against the extensive resources and network advantages of Verizon, which Cox has used to its advantage by adopting portions of or the entirety of interconnection agreements negotiated by AT&T and MCI.

CALTEL and Covad further argue that the ability of the private sector to adequately regulate interconnection agreements may disappear, and costs will increase when competitors are no longer able to rely on MCI-negotiated agreements. They contend that the concept of self-regulation was central to the Telecommunications Act deregulatory approach to interconnection rights and depended on the creative tensions between companies with different objectives but equivalent resources. Relative resources of the competitors versus the incumbents will shrink from a 90% percent ratio in 1996 to a 4% ratio after the mergers.[29]

XO argues that the resulting imbalance will cause the existing regulatory regime to suffer. CALTEL and Covad argue that the merger disrupts the core assumption of the Telecommunications Act – namely that new entrants and incumbents should have the ability to negotiate as equals. They add: "The merger could not conceivably be in the public interest if one of its consequences

[29] CALTEL & Covad, Gillan, p. 10 – 14.

would be a resource imbalance so severe that Verizon could effectively litigate its competitors out of the market."[30]

Whether the irreversible decline of MCI is inevitable or not, we must examine the impact of the absence of MCI on the regulatory tension between the incumbents and the competitors because MCI will not be a future presence in the regulatory arena. CALTEL, Covad and Cox have advanced objective analysis for a factor that has been anecdotally obvious to observers of the telecommunications policy debate, *e.g.* that MCI (and AT&T) have provided the leadership and resources to advance the competitive agenda both in this forum and nationally.

It is unknown whether a CLEC with fewer resources will have the ability to engage in an arbitration of an interconnection agreement that lasts over a protracted period of time or to fully participate in a proceeding – such as the FCC's Triennial Review – that is crucial for the future of competitive interests. That there will be an impact because of regulatory changes on the competitive landscape is certain, with the elimination of both MCI and AT&T as competitors and the elimination of UNE-P by the FCC as a vehicle for competitors to provide service. We will seek to lessen the advantage of companies with the resources to serially arbitrate provisions of interconnection agreements or to litigate or lobby their competitors out of business by adopting mitigating measures as discussed in a later section of this decision.

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30 CALTEL & Covad, Gillan, p. 6, l.12

6.1.1. Analysis by Market

6.1.1.1. Mass Market/Small Business

Verizon has few wireline competitors for mass market customers. Applicants currently compete in both the local and long distance residential markets, while all parties (including Applicants) agree that virtually all competition related to UNE-P services will no longer be viable in the near future, Intervenors contend that without wireline competition from the two largest competitive entities, AT&T and MCI, the mass market will have to rely on intermodal competition to constrain Verizon's market power in its service territory and its resulting ability to increase prices. Virtually all of the intermodal competitors are based on prices significantly higher than Verizon's flat-rate residential service—for example, VoIP requires a cable modem connection (without so-called "naked DSL" discussed later) in addition to its monthly rate.[31] Cell phones service plans typically range around $40 for plans with enough "included" minutes to compare with a local access line. Neither of these options, nor cable telephone, appears to be presenting a significant price pressure on Verizon.

6.1.1.2. Enterprise Customers

MCI is a direct competitor of Verizon in the enterprise market, and there is no basis for concluding that, absent the merger, Verizon would not continue to be an aggressive competitor for enterprise business. One of MCI's major strengths is its position in the enterprise market. All witnesses agree that the combined company will play a significant role in this market.

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[31] Ex. ORA 1 (Selwyn) at Table 4.

6.1.1.3. Internet Network Services

MCI is a Tier 1 Internet backbone network service provider, which means that it is able to exchange traffic with the other Tier 1 providers on a "peer-to-peer" basis without any cash payments. Verizon, on the other hand, currently provides the plurality of high-speed Internet services to California customers via its DSL offerings. According to ORA, the integration of these two networks will provide an incentive for Verizon/MCI (and SBC/AT&T) to become "mega-peers" and distort the current competitive Internet peering and intercarrier payments mechanism. A number of competitive Intervenors contend that the two "mega-peers" (Verizon and SBC) will fundamentally change the conditions under which they are willing to "peer" with smaller, non-integrated Internet backbone providers (IBPs), thereby cutting these entities out of the "peering" system and imposing out-of-pocket cash payments for interconnections with the Verizon and SBC backbones. IBPs allege that such an outcome would have a far-reaching impact upon competition for Internet services at all levels, from mass market consumer ISP services to those associated with large host sites and large enterprise customers. Verizon's response to this argument focuses upon repudiating the ability of Verizon to impose a retail-level price squeeze on cable companies and other ISPs.

The Commission's role in dealing with this dispute is limited, since primary jurisdiction for Internet regulation is with the FCC, which has considered peering allegations in its consideration of the Verizon/MCI and SBC/AT&T mergers.

6.1.1.4. Special Access

ORA's witness cited analysis filed in the FCC proceeding to show that, once MCI and AT&T no longer submit separate competitive bids, the wholesale price discount from special access rates will decrease on average by over 15%--resulting in an overall increase in special access rates. Applicants assert that increasing special access rates is only possible where Verizon has obtained pricing flexibility-and that such flexibility, under FCC rules, is only granted where Verizon faces competitive pressure.

6.1.1.5. Intermodal Competition

Applicants argue that the presence of intermodal competition from wireless, VoIP, and cable telephony offsets the elimination of MCI as a competitor of Verizon since the presence of such services limit Verizon's market power and constrain its ability to impose monopoly prices. Intervenors, however, argue that Applicants have provided no evidence of cross-elasticity estimates between basic wireline telephony and wireless or other "intermodal" services.[32] Applicants' witness Rubinfeld contends specific quantitative measures of elasticity cannot now be made, adding, "Because many of the dynamic changes in the competitive landscape have occurred so recently, it is too early to expect to see an extensive series of empirical studies relevant to market definition (e.g., accurate estimates of own- and cross-price elasticities of demand)." Intervenors argue that it is this lack of empirical studies that renders Applicants' claims of intermodal substitution too speculative to overcome the quantifiable increases in market concentration that the evidence shows will result from the merger.

We note, as do Intervenors, that Verizon is itself a major presence in each of the intermodal alternatives. Verizon holds a controlling 55% share of Verizon

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[32] Ex. ORA 1 (Selwyn) at 96.

Wireless, the nation's second-largest wireless carrier. Following its merger with MCI, Verizon will be a major player in VoIP, adding to its local network with MCI's Tier 1 Internet Backbone Provider. Verizon also intends to become a major player in the cable television market, having announced an ambitious fiber-to-the-home (FTTH) distribution architecture over which it will provide voice, data, and video.

6.1.1.6. Additional Mitigation Measures

Given the evidence that the Verizon/MCI entity will have increased market power and an enhanced ability to increase rates because of lessened competition, ORA and TURN propose additional measures to mitigate the risk that any net ratepayer benefits from the merger may be taken away through rate increases, particularly for mass market customers. They urge that Applicants be required to:

1. Maintain a five-year rate freeze for residential and small business basic local exchange services, including 1FR, 1MR, 1MB customers. ORA adds residential inside wire maintenance plans to the list of services.
2. Make the above services available to consumers on a stand-alone basis without any requirement to purchase other bundled services.
3. List the separate availability of these services prominently (noting that there is no requirement to purchase other bundled services) in their phone books and in any advertising on Web sites or through bill inserts.
4. Retain a pricing option for California-jurisdictional long-distance calling that does not have any minimum monthly charge or fee.

Underserved consumers, including low-income, minorities, and those with disabilities are particularly concerned about the trend of companies offering telecommunications services in bundles to residential consumers, and the resulting impact on the affordability of basic phone service. Because consumers with disabilities are disproportionately represented among low-income consumers, they have a particular interest in ensuring that basic and affordable telephone service will be provided by the new entity.

We will adopt the recommendation of ORA and TURN for a five-year cap on the residential and small business basic exchange services, including inside wire maintenance plans. This condition will mitigate the risk that residential and small business ratepayers would face rate increases to pay for the short-term implementation costs of the merger. We also adopt the recommendation to make these basic services available on a stand-alone basis, to separately list the service in web sites and through bill inserts, and to retain a pricing option for long-distance calling with no minimum monthly fee. These conditions shall remain in effect during the five-year rate cap period.

6.1.1.7. Jurisdiction to Address Impacts Involving Federally Regulated Services

Since both federal agencies and this Commission are reviewing the proposed merger's public interest aspects, certain jurisdictional questions have been raised. Parties disagree concerning whether Commission review of competitive impacts under § 854 (b)(3) properly includes consideration of impacts that may involve services subject to federal regulation or review. Applicants argue that competitive impacts of such services are beyond the jurisdiction of this Commission and are more properly left for review by federal agencies.

We conclude that even to the extent that certain competitive effects of the merger may relate to services subject to federal regulation, our authority under

§§ 854 (b) and (c) is sufficiently broad to encompass consideration of such effects. Section 854 (b) (3) requires, as a basis for approving this transaction, that we consider whether the proposed acquisition will adversely affect competition, as well as conditions to mitigate adverse impacts. The statue does not carve out exceptions to this requirement only for certain categories of services or competitive impacts. As we stated in D.91-05-028,

> "This Commission's statutory authority to determine whether the proposed merger should be authorized, based upon the assessment of competitive impacts and their potential mitigation (§ 854(b)(2)) is meaningfully exercised only if this Commission is free to engage in the <u>full extent of the merger's impacts</u> on California ratepayers. The statute requires that we assess whether the merger will impact competition. If that assessment requires us to take into account certain issues regarding interstate transmission and bulk sales, <u>then that is what we must do.</u> Furthermore, as an administrative agency created by the Constitution, <u>we have no power to refuse to enforce § 854(b)(2) on the basis of federal preemption</u>, unless an appellate court has made a determination that enforcement of the statute is prohibited by federal law or federal regulation. (Cal. Const. Act. 3, § 3.5. (40 CPUC 2d, 159, 179.) (Emphasis added.)

To the extent that we impose conditions on approving this proposed merger, we do so only within the context of our obligation to assure that the merger is in the public interest pursuant to § 854. If the Applicants decide not to go forward with the merger, they would not be required to implement the mitigation measures we adopt. Thus, we are acting within the scope of the Commission's jurisdiction under § 854(b)(3).

6.1.1.8. Attorney General's Opinion

Although maintaining that § 854(b)(3) does not apply to the Verizon/MCI merger, the Assigned Commissioner in this case nevertheless requested an advisory opinion from the California AG concerning whether competition will be adversely affected by the merger, and, if so, what mitigation measures might be adopted to avoid this result. While the AG's opinion is not controlling, we accord it due weight in our deliberations.[33]

The Advisory Opinion was filed on September 16, 2005. In analyzing the competitive effects of the merger, the AG employed the approach embodied in the antitrust laws, including the DOJ and FTC 1992 Horizontal Merger Guidelines and the April 8, 1997 revisions. Following traditional analysis, the Guidelines analyze the effect of a consolidation upon the "relevant markets" within which the parties do business.

In summary, the AG expresses concern that the merger may adversely affect competition for two types of special access, namely, DS1 and DS3 services, but adds that there is sufficient competition to counteract any potential anticompetitive effects of the merger on these special access services. The AG concludes that the competitive effects of the proposed merger will be minimal for other relevant markets, including those for mass-market local and long distance, enterprise, and Internet backbone services.

ORA maintains that the AG has inappropriately focused upon "facilities-based" competition to the exclusion of "retail" level competition. The AG states:

> Verizon has a relatively minor presence in the relevant markets for both mass market (facilities-based) long distance and enterprise services, MCI dominates neither of those highly competitive industries, and entry barriers there are relatively minor. Similarly, MCI has a nominal share of the relevant market(s) for facilities-based local

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[33] D.97-03-067, 71 CPUC2d 351, 420, footnote 31. Also see Attorney General's Opinion, page 3, citing Moore v. Panish (1982) 32 Cal.3d 535, 544, and Farron v. City and County of San Francisco, (1989) 216 Cal.App.3d 1071.

exchange services, and its absence will have inconsequential effects on price and output levels."[34]

According to ORA, the AG appears to equate "resale" with "retail," and "facilities-based" with "wholesale," when in fact a facilities-based carrier also competes at the *retail* level. ORA asserts that the AG Opinion is not simply *distinguishing* between the facilities-based and retail segments of the two Applicants' respective businesses, it is essentially *ignoring* all but the "wholesale" facilities-based service production activities.

Because we conclude that the relevant market is for facilities-based services, we do not consider the question of whether MCI can still be considered an active and competitive supplier of resold services.[35]

The AG Opinion supports its decision to ignore "resale" by observing that UNE-P is a "readily available" service that can be used by CLECs to compete at the retail level. The AG "conclude[s] that because there are numerous suppliers of resold UNE-P telephone services, the relevant market for analyzing the effects of the merger on local exchange services is at the facilities-based level where suppliers own at least their own switches."[36] However, the AG Opinion then acknowledges that UNE-P will no longer be available in the future.

Similarly, TURN contends that the AG's relevant mass market definition is contradicted by the FCC's, which includes resellers in assessing competition; and that it is contradicted by the DOJ merger guidelines that require all firms currently producing or selling in the market be included in the analysis.

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[34] AG Opinion at 11.

[35] AG Opinion at 12.

[36] AG Opinion at 9.

Facilities-based services are not the only method of entry into the local market envisioned by Congress. The 1996 Act specifically allows for local competition through the resale of telecommunications services and the purchase of unbundled network elements.[37] According to ORA, by limiting its assessment of the potential anticompetitive effects of the merger only to facilities-based competition, the AG Opinion ignores the extensive retail-level competition between Verizon and MCI that the merger will eradicate. ORA contends:

> [S}ince most California ratepayers are dealing with the Joint Applicants solely at the *retail* level, by ignoring the retail end of the market, the AG Opinion offers the Commission no useful guidance whatsoever as to the specific public interest issues that the Commission is charged with addressing pursuant to § 854(a) in conjunction with PU Code § 451.[38]

It seems clear to us that in analyzing the merger pursuant to § 854, the Commission's concern must necessarily be focused primarily on California. However, the AG appears to adopt a national perspective in analyzing the competitiveness of the U.S. telecom industry. For instance, in assessing the mass market long distance services, the AG Opinion relies upon the following FCC findings:

> …that competition among long distance suppliers is both substantial and national in scope. AT&T, MCI, and Sprint served the vast

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[37] *See* 47 U.S.C. § 251(c)(3) and (4).

[38] Section 451 requires that all rates "by any public utility," including telephone companies, "shall be just and reasonable."

> majority of the market when the FCC found for the first time in 1995 that it was "structurally competitive.[39]"
>
> …that the United States is the relevant geographic market for assessing competition among long distance suppliers.[40]

The first of these FCC findings was made in 1995, before the federal Telecommunications Act of 1996 was enacted, and at a time when none of the regional Bells was permitted entry into long distance. The second FCC finding was made in 1998 in the context of the then-proposed merger of WorldCom and MCI, two interexchange carriers, neither of which had any significant presence in the mass market local service segment. In addition, it was more than two years before any of the RBOCs had been granted authority pursuant to § 271 of the 1996 Act to offer interLATA long distance services.[41]

Congress has since recognized that the "relevant geographic market" for long distance service, post-RBOC entry, is *not* national in scope. Section 271(b)(2) of the 1996 Act authorizes RBOC long distance entry *out-of-region* immediately as of the date of enactment.[42] But § 271(b)(1) provides that "A Bell operating company, or any affiliate of that Bell operating company, may provide interLATA services originating in any of its in-region States (as defined in subsection (i)) if the Commission approves the application of such company for

[39] AG Opinion at 13 (footnote omitted).

[40] AG Opinion at 14.

[41] 47 U.S.C. § 271.

[42] 47 U.S.C. § 271(b)(2).

such State under subsection (d)(3)" thus clearly contemplating a *state-by-state* compliance analysis.[43]

The AG Opinion focuses on the national markets and on facilities-based services. It also does not address the fact that Verizon will increase its market shares. Verizon controls much of the critical last mile infrastructure in its service territory. Because of Verizon's already-dominant position, the elimination of one of its largest competitors should not be minimalized simply because MCI uses UNE-P for its local exchange services.

Accordingly, we will not rely primarily on the AG Opinion, but will also give substantial weight to parties' expert testimony proposing further conditions.

7. Application of § 854(c)

Since we have found that all of § 854 applies to the Verizon/MCI merger, we are required to conduct a review using § 854(c) to guide our determination of whether this transaction is in the public interest. The § 854(c) criteria cause us to ask whether this transaction:

1. Maintains or improves the financial condition of the resulting public utilities doing business in California?
2. Maintains or improves the quality of service to California ratepayers?
3. Maintains or improves the quality of management of the resulting utility doing business in California?
4. Is fair and reasonable to the affected utility employees?
5. Is fair and reasonable to a majority of the utility shareholders?

[43] 47 U.S.C. § 271(b)(1).

6. Is beneficial on an overall basis to state and local economies and communities in the area served by the resulting public utility?
7. Preserves the jurisdiction of the Commission and its capacity to effectively regulate and audit public utility operations in California?
8. Provides mitigation measures to prevent significant adverse consequences which may result.

Finally, the Commission must consider the implications for competitive markets of the application as well as any environmental impacts.

7.1. Will the Change of Control Maintain or Improve the Financial Condition of the Resulting Utilities Doing Business in California?

Applicants state that "because this transaction will occur at the level of the parent holding companies, it will have no structural impact on any of the MCI subsidiaries. The transaction will maintain or improve the financial condition of the MCI subsidiaries," since the new company will have the resources to invest in MCI's facilities.[44] Beyond this, Verizon is an established communications provider with a strong balance sheet, investment grade credit and the financial, technological and managerial resources to invest in MCI's network and systems.

MCI states that "the combined company will be in a strong financial position to invest in the existing IP network at a lower cost of capital than MCI could obtain on its own,"[45] and Verizon states that "absent this transaction, Verizon would have to spend its resources duplicating, at least to some extent,

[44] Application Section X(A) and Verizon/MCI 3, Section VII(A).

[45] Verizon/MCI 4, Section VI.

the presence and network assets MCI already has in place."[46] They add that "the combined company will have greater financial strength and flexibility than either company could achieve alone because of its greater size and complementary strengths and assets."[47]

Applicants also state that "with respect to the mass market, MCI's business is already in decline due to a variety of factors unrelated to this transaction, and MCI would not, absent its deal with Verizon, be one of the more significant competitors going forward for mass market customers."[48] The decline of MCI's mass market business is explained in detail in Ex. Verizon/MCI 4, Section IV.

In addition, Applicants state that the increased financial strength of the combined company will support additional investments in advanced technologies. Verizon notes a commitment to invest $2 billion in MCI's networks and information technology systems, including its Internet backbone. In addition, Verizon states that it examined whether this transaction would be expected to impair the parent company's ability to attract capital, and determined that it would not. No credit downgrade has occurred and Verizon reports that none is expected. Applicants conclude that: "consistent with Commission precedent, the transaction will maintain or improve the financial condition of the affected California utility subsidiaries and thus satisfies the concerns of § 854(c)(1)."[49]

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46 Verizon/MCI 3, Section V(A).

47 Verizon/MCI 3, Section VII(A).

48 Verizon/MCI 3, Section VI.

49 Joint Applicants Opening Brief, p. 46.

ORA argues that the merger may increase the potential for the parent company and affiliates to exploit the regulated utility and cause the latter financial harm. ORA states that Verizon California's revenues make up only a small percentage of its parent company's revenues and that after the merger, that percentage will be even smaller. Therefore, ORA concludes that is unlikely the holding company will make decisions based on the interests of Verizon California and its California ratepayers. In ORA's view, inappropriate cost allocation and the overcharging of regulated entities by their unregulated affiliates have occurred in the past. ORA recommends that the Commission require the imposition of a "first priority condition" for Verizon to mitigate possible exploitations that affiliates may place upon Verizon California.[50]

TURN argues that the Applicants have failed to show that the proposed merger will maintain or improve the financial condition of the resulting public utility doing business in California. In particular, TURN contends that the Applicants merger will have a negative financial impact on the merged entity for several years. TURN concludes that it is "implausible that the merger could improve the financial condition of the Verizon-CA utility in the short-run and it is likely to do at least some harm."[51]

We find that this merger will maintain or improve the financial condition of the resulting public utility. First, the transaction, with the resulting influx of $2 billion investment into MCI, will improve the financial condition of that utility. Second, Verizon has demonstrated that the transaction will not impair

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50 ORA, Opening Brief, p. 41, citing Ex. ORA 3, pp. 12-13.

51 TURN, Opening Brief, p. 71.

the holding company's ability to attract capital, and no credit downgrade has occurred or is expected.

ORA's financial concerns largely focus on the holding-company structure of organization rather than the specifics of the transaction. ORA claims that the holding company structure will lead to adverse financial consequences for the California utilities owned by Verizon. ORA fails to note that Verizon's California utility is already a small part of a large holding company, and thus ORA's concerns are largely unrelated to this transaction. Despite the fact that this holding company structure has been in place for some time, the Commission has seen no negative consequences for the Verizon California utility that have resulted. Moreover, ORA has not demonstrated that any adverse consequences are even plausible.

TURN claims that Verizon has simply failed to demonstrate that the merger will produce no adverse consequences, and notes that the initial impact of the merger is projected to have negative consequences on finances. Our examination of the evidence leads to a different conclusion. We find that Verizon has demonstrated that this transaction will improve the financial situation of MCI's California utilities and that the transaction will not have an adverse impact on Verizon's California utilities. We conclude that the merger will meet the standard of § 854(c)(1). Moreover, we note that TURN's focus on short-term financial flows adopts a "cash" approach, which treats investments as an expense in the year in which it they are made, instead of converting investments into an annual expense based on depreciation and a return on unamortized investment. This later approach is the one more typically used by the Commission.

7.2. Will the Merger of the Parent Companies and the Change of Control Maintain or Improve the Quality of Service to California Ratepayers?

Verizon, citing D.03-10-088, notes that the Commission has found that Verizon provides exceptional and high-quality service, and that its overall service is consistent with the Commission standards set forth in General Order 133-B. It further states that its continuing commitment to providing high quality service will not be affected by the transaction. In support of this position, the Applicants state that the "structure and operation of the various utility subsidiaries will remain in place, as will the skilled workforce required to operate them."[52] The Applicants note that the current companies are the products of numerous prior mergers, and therefore "possess the technical and managerial expertise to maintain focus on customer service and service quality both during and after corporate reorganizations."[53] The Applicants further state that the increased financial strength and the investments that will follow the merger will support future service quality. Finally, the Applicants cite testimonials given at the public participation hearings as supporting its view that the stronger company will be able to provide better service quality.

ORA states that it does not dispute Verizon's claim that it had excellent service quality in the period 1990-2001, but argues that service quality, especially as measured by "residential repair interval," has declined since 2001. ORA also states that there has been "a substantial volume of customer complaints about

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52 Joint Applicants' Opening Brief, at 47.

53 *Id.*

MCI's service"[54] and recommends an investigation of MCI's local service quality. In addition, ORA recommends the imposition of penalties for service outages and a requirement to maintain or improve service quality. In particular, ORA recommends an investigation of service quality in the Verizon West Coast service territory.

TURN argues that the Applicants have failed to prove that the merger will maintain or improve the quality of service provided to California ratepayers. TURN speculates that MCI's poor practices will infect Verizon and states that the Applicants' assertions concerning quality as vague. TURN also argues that the poor financial situation of MCI is more likely to be a drag on investment by Verizon and more likely to slow down Verizon's network investments.

DRA states the merger is "not in the interests of public utility ratepayers with disabilities."[55] DRA alleges that a shift in focus to the enterprise market "threatens service quality for people with disabilities."[56]

On the evidence before us, we find that the merger is likely to maintain or improve service quality. Current operations and networks are largely complementary, with little overlap. No integration of the two companies at the operational level is contemplated at this time. As a result, it is unlikely that the merger will have any impact on service quality in the short run.

Verizon has a record of excellent service quality, and it seems to us more likely than not that the service quality orientation of the larger acquiring entity will cause an improvement in the service of the acquired company. Verizon's

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54 ORA Opening Brief, p. 47.

55 DRA Opening Brief, at 2.

56 DRA Opening Brief, at 3.

record concerning the provision of telecommunications services to the disabled community and its demonstrated commitment to disabled access make the concerns raised by DRA dubious. In the long run, the record before us suggests that the merger will result in improved service quality for both the general customer base and the disabled community.

Had evidentiary hearings and cross-examination been conducted in this proceeding, we might have more evidence before us dealing with service problems, particularly in the Verizon West Coast service territory. As it is, however, there is no credible basis in this record for ordering the investigations into service quality that ORA recommends.

7.3. Will the Merger of the Parent Companies and Changes of Control Maintain or Improve the Quality of the Management of the Resulting Utility Doing Business in California?

Applicants state that MCI's "consumer business is in a continuing and irreversible decline due to an array of factors," which include competition from wireless and other technologies, and that the merger will allow MCI to "capitalize on its strongest assets…by teaming with a company that needs those assets and will invest in them."[57]

Applicants further contend that the merger "will have no immediate effect on the management of Verizon's California subsidiaries." They also state that there "will be no diminution in the management quality of MCI's subsidiaries …Verizon has an interest in preserving this quality because access to MCI management's skills and expertise in one the reason Verizon entered into the

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[57] Application at 13

Agreement." In addition, they state that "the management of the combined company will be drawn from the current management of both Verizon and MCI."[58]

Intervenors do not question the impact of the merger on the new company's quality of management. We do not find any evidence that the proposed merger will have a negative affect on the resulting public utility's quality of management. We find that the merger will maintain or improve the quality of management of the resulting public utility.

7.3.1.1. Will the Merger of the Parent companies and Change of Control Be Fair and Reasonable to the Affected Employees?

Applicants state that "the Agreement does not call for a combination of the operations of Verizon's and MCI's operating subsidiaries. Employee reduction from the transaction will most likely occur due to the consolidation and elimination of redundant positions,"[59] and that "planned staffing reductions will eliminate redundant positions and will primarily be accomplished, to the extent possible, by attrition, retirement and other voluntary means."[60] In addition, "the synergies created by the Verizon-MCI transaction should benefit the employees of both companies' California subsidiaries by providing additional opportunities for employment," and that "by creating a far stronger company with the ability

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[58] Application at 30.

[59] Verizon/MCI 3 at 25.

[60] Application at 32.

to grow and prosper, there should be a higher degree of stability and certainty for employees."[61]

TURN questions Applicants' assertion that the operations of the merging companies are not being combined, if at they same time they are reducing their workforce. TURN states, "Whether or not the merger results in a structural consolidation of operations, it will result in fewer employees in those operations."[62]

ORA argues that the merger will have a negative effect on both employees and the California economy. It claims that the merger "has a potential to eliminate hundreds of high-paying California jobs"[63] and estimates a loss of at least $807 million to the state economy. ORA recommends that the Commission "limit California job counts to no more than 5% of MCI's total headcount reductions"[64] as a condition of the merger.

Applicants refute ORA's analysis of potential headcount reductions, which Applicants say "assumes that an arbitrary percentage of California employees would be let go, without regard for how MCI's current operations are geographically organized or the new company's likely business strategy."[65] They state that MCI is not planning on making proportional reductions in each state. Instead, Applicants state that there will be reductions of particular staff

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[61] Verizon/MCI 3 at 25.

[62] TURN Opening Brief at 75.

[63] ORA Opening Brief at 48

[64] ORA Opening Brief at 58.

[65] Applicants' Opening Brief at 49.

positions that will become redundant after the merger, and that "the impact of such cutbacks on California employment will be negligible, because MCI has few such employees located in California to begin with."[66] Verizon also addresses this issue by stating that "The companies have not yet begun post-merger planning and it is unknown how many California positions might be affected, but certainly there are no facts which lead to a conclusion that any job cuts or post merger employment conditions will be unfair."[67]

Verizon and MCI state that they have, respectively, approximately 18,000 and 2,500 employees in the state of California, representing 8.6% of Verizon's national workforce and 5.9% of MCI's international workforce. Verizon's website states that approximate 7,000 jobs will be lost due to this merger.[68] If the California layoffs are proportionate to the companies' workforce as a whole, between 400 and 600 jobs will be lost in the state. Applicants state that the layoffs will *not* be proportionate, because of the type of jobs considered redundant are most likely not located in California facilities. However, Applicants do not estimate how many California-based jobs will be lost by this merger, which California facilities will be affected, or how these jobs losses will affect employee diversity. They also do not state whether employees laid off in the short term will be given preference for new positions created in the future when the expected growth of the merged company occurs, or about any other arrangement being made to ease the transition for affected workers.

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[66] Verizon/MCI 24(c) at 23-24.

[67] Verizon/MCI 23(c) at 28.

[68] http://investor.verizon.com/news/20050214/20050214_bw.pdf, p. 28.

Analysis by our Telecommunications Division staff of proprietary information tends to support the conclusions of ORA as to the impact on California jobs. We conclude that because Applicants have not yet offered any significant data on the impact of headcount reductions in the state of California, it is important that the Commission have a means by which to examine this issue in the future. We determine that as a condition of the merger, Applicants shall be required to report to the Commission in one year's time on the impact of employee layoffs, on both union and non-union employees, in the state of California, and the Commission reserves its right to impose mitigating conditions at that time if necessary.

7.3.1.2. Will the Merger of the Parent Companies and Change of Control Be Fair and Reasonable to a Majority of the Utility Shareholders?

Applicants state that the merger will benefit their shareholders because of the proposed economic growth of the new company and because it will "eliminate duplicative expenses and create operational efficiencies."[69] Applicants also point out that both Verizon and MCI's board of directors voted for this transaction and that a majority of MCI's shareholders have voted to accept the merger. Accordingly, we find that § 854(b)(5) has been satisfied.

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[69] Applicant Opening Brief at 50.

7.3.1.3. Will the Proposed Merger of the Parent Companies and Change of Control Be Beneficial on an Overall Basis to State and Local Economies and the Communities Served by the Resulting Utility?

The Applicants argue that the transaction "will result in overall benefits to the State of California and all of its constituencies."[70] The Applicants state that the transaction will promote competition and result in improved service quality and more competitive prices. The Applicants further state that the transaction will be beneficial on an overall basis to state and local economies, and the communities in the areas served by the resulting public utility. Specifically, the Applicants state that the merger will produce cost savings and other synergies that will be passed through to California customers through competition and market forces. They also state that transaction will also result in the combined company's ability to offer a broader range of services, and more advanced services, to California consumers. The Applicants argue that the transaction will promote competition in communications in California, resulting in improved quality of service, more competitive prices, and greater technological innovation that will inure to the benefit of customers. Furthermore, the Applicants state that Verizon has a strong tradition of community support, community service, and corporate philanthropy, which it states it "will continue after this transaction."[71]

ORA argues that the transaction will have a negative effect on the California economy, citing its testimony and arguments concerning employment. TURN argues that the Applicants have failed to "meet a reasonable burden of

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[70] Joint Applicants Opening Brief, p. 51.

[71] Joint Applicants Opening Brief, at 52.

proof that the proposed [merger] will not harm the state and local economies in California."[72]

We find that with the mitigating conditions that we adopt in our order, the transaction will benefit Californians. Pub. Util. Code § 709 identifies access to advanced telecommunications service as a key public policy objective. Several parties to the proceeding identified enhanced access to high speed Internet (broadband) and advanced telecommunications services as a primary benefit to consumers embodied in this transaction. Applicants state that "the transaction is intended to complement and accelerate Verizon's continuing transformation into a premier wireless and broadband provider," and will "further its investment strategy to bring enhanced broadband capabilities to the mass market."[73] We are presented with no evidence that contradicts that assessment.

7.3.1.4. Will the Proposed Merger of the Parent Companies and Change of Control Preserve the Jurisdiction of the Commission and its Capacity to Effectively Regulate and Audit Public Utility Operations in California?

Applicants state that because the transaction will not affect the structure of MCI Subsidiaries, the Commission's ability to regulate those subsidiaries will not be diminished. Applicants state that all MCI subsidiaries will continue to be subject to all the terms and conditions that the Commission previously required. Applicants further state that the transaction will not adversely affect the

[72] TURN Opening Brief, at 76-79; TURN Reply Brief, at 50.

[73] Application, at 12 and 13.

Commission's jurisdiction nor its ability effectively to regulate the combined company's public utility operations in California.

Although no party alleges that the transaction diminishes the Commission's jurisdiction, several raise questions concerning the capacity of the Commission to continue to regulate utility operations in a new market environment. ORA states that "MCI, with AT&T, has been one of the most vigorous CLEC voices in Commission proceedings, frequently representing interests in conflict with those of SBC and Verizon."[74] In addition, both ORA and TURN claim that the regulatory task of auditing will become more complex, and ORA proposes that the Applicants fund two $1 million audits after the merger.

We find that the transaction will not diminish the jurisdiction of the Commission or its capacity to regulate and audit utility operations in California. First, we note that nothing in this transaction affects the jurisdictional authority of this Commission. Second, the allegations by TURN and ORA that the merger will decrease the Commission's regulatory capacity are unsubstantiated.

As to audits, we note that the Commission's decisions in D.04-02-063 and D.04-09-061 demonstrate that changes in industry structure have not diminished the Commission's authority or capacity to audit utility operations. Even as corporate structures have become more complex, the ability of the Commission to exercise regulatory oversight has adapted with regulatory structures more attuned to the competitive environment, including a shift from traditional rate-of-return regulation to price cap regulation in the telecommunications industry, while at the same time maintaining the Commission's auditing authority.

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[74] ORA Opening Brief, at 50.

7.3.1.5. Does the Proposed Merger of the Parent Companies and Change in Control Create Environmental Issues of Concern?

The Applicants state "this transaction is occurring at the parent, holding company level and involves no creation or consolidation of existing physical assets."[75] The Applicants state that "The Commission has consistently held that the indirect transfer of ownership of facilities, as is the case with this transaction, does not raise significant environmental concerns."[76]

No party has raised environmental issues concerning the proposed financial transaction. We find that this application raises no environmental issues of concern.

7.3.1.6. Does the Transaction Provide Mitigation Measures to Prevent Significant Adverse Consequences Which May Result?

The Applicants argue that, consistent with the wording of Pub. Util. Code § 854(d), "mitigation measures should be imposed only if necessary to mitigate some 'significant adverse consequences that may result' from the transaction." The Applicants argue that the Commission has consistently refused to approve merger conditions unrelated to the issues raised by the merger itself. The Applicants accuse the Intervenors of using this proceeding as an opportunity to satisfy their own agendas by attempting to impose merger conditions unrelated to the transaction itself. The Applicants argue that the "Commission should not accede to Intervenors' attempts to fulfill their wish-lists by imposing conditions

[75] Joint Applicants Opening Brief, at 55.

[76] Joint Applicants Opening Brief, at 56 (footnotes omitted).

that have little or nothing to do with the transaction itself."[77] Applicants claim that since the transaction does not produce significant adverse consequences, no conditions are appropriate.

CALTEL proposes a series of mitigation measures, including: 1) a price cap plan for Verizon's wholesale network elements; 2) a requirement that Verizon provide fair interconnection prices, terms and conditions for IP facilities and capabilities; 3) the imposition of a cap on Verizon's intrastate special access rates for five years.

Cox cites § 854(c)(8) and argues that the Commission is required to provide mitigation measures. Cox then argues that three conditions are needed: 1) a condition allowing CLECs to opt-in to interconnection agreements that Verizon has negotiated and/or interconnection agreement provisions that Verizon has arbitrated in California; 2) a condition requiring Verizon to transit traffic consistent with TELRIC pricing and free of burdensome and unnecessary restrictions; and 3) a condition requiring Verizon to offer extensions on existing IP backbone agreements.

Level 3 asks for 1) divestiture of overlapping in-region facilities; 2) a series of conditions on special access pricing; 3) a requirement that Verizon exchange all VoIP traffic at the local compensation rate; 4) a requirement that the merged company return unused telephone number blocks; and 5) a requirement that Verizon offer stand-alone DSL.

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[77] Joint Applicants Opening Brief, p. 57.

ORRA proposes an extensive set of requirements tied specifically to the various elements of § 854(b) and § 854(c). A summary is provided on pages 54-59 in ORA's Opening Brief.

Pac-West proposes a merger condition to "ensure the availability of non-discriminatory interconnection with the packet-switched network facilities of Verizon."[78] The condition is:

> In the absence of a negotiated agreement acceptable to any requesting CLEC, Verizon's affiliates certificated as public utilities in California shall consent to participate in arbitration proceedings conducted by this Commission pursuant to Section 252 of the Communications Act, the purpose of which shall be to establish reasonable and non-discriminatory terms and conditions of interconnection between the networks of Verizon's certificated affiliates in California and the network of the requesting CLEC. This interconnection shall include all technologies and network architectures deployed by the Verizon affiliates in California, including but not limited to all packet-switched network technologies. As a condition of this merger, Verizon shall further waive any claims that such interconnection obligation involving all of its deployed network architectures exceeds the scope of permissible arbitration under Section 252.[79]

Qwest proposes six conditions for the merger: (1) divest all overlapping facilities;(2) institute a price freeze on special access; (3) show no favoritism post-merger to new affiliates; (4) agree to resell services purchased from other ILECs out of region; (5) give a "fresh look" right for customers to terminate all contracts; (6) agree to offer stand-alone DSL.

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[78] Pac-West Opening Brief, at 25.

[79] Pac-West, Opening Brief, p. 25, citing Pac-West Ex. 1, p. 28.

Telscape asks that the Commission require Verizon to sell its UNE-L facilities at a 50 percent discount.

TURN's chief focus is in contesting approval of the merger, and proposed conditions are only part of TURN's showing. If the application is approved, TURN proposes these conditions:

1. A five-year rate freeze for residential and small business basic exchange rates;
2. A requirement that the 1FR, 1MR, 1MB, and local measured usage and ZUM services be available on a stand-alone basis.
3. A requirement that Applicants agree to prominently list the availability of these services in phone books, on the web, and in bill inserts;
4. A requirement that Applicants offer intrastate long distance calling without a minimum monthly fee;
5. A requirement that Verizon provide a competitive alternative for residential and small business customers in SBC's service territory no later than 18 months from the consummation of the merger.
6. The submission of quarterly reports on the progress of competitive offerings.
7. The imposition of a non-trivial penalty, "e.g., $10 million," each month if Verizon fails to meet a "target of providing meaningful competitive alternative within 18 months."[80]
8. Adopt a cost of capital now for use in upcoming UNE proceedings;

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[80] TURN Opening Brief, p. 166.

9. Make approval conditional upon Applicants' agreement to fund independent third-party monitoring of competitive conditions in California;

10. Require corporate affiliates to cooperate with third-party monitoring;

11. Reequire Applicants to agree to the service quality monitoring recommendation outlined in TURN's Comments in the Rulemaking on General Order 133-B;

12. Adopt further conditions to require the tracking of the deployment of new technology by wire center, along with statistics about wire center demography;

13. Make Commission approval contingent on Applicants' agreement to fund two independent audits of Verizon's affiliate transactions;

14. Require Applicants to commit in writing that all corporate affiliates of Verizon will make their books and records available for inspection by Commission staff and the third-party auditor;

15. Require that Applicants modify their standard non-disclosure and protective agreement so that it allows parties to use material obtained in one Commission docket in any other regulatory proceeding as long as the confidentiality of the information is maintained.

DRA argues that the Commission should adopt merger conditions in six areas: (1) ensure that Applicants maintain and improve customer service for customers with disabilities; (2) require that Applicants renew their commitment to universal design principles; (3) require improvements in accessibility of all communications; (4) improve polices related to bundled services and basic phone service; (5) ensure that an internal committee for voicing the concerns of the disability community is created; (6) establish auditing and reporting requirements.

Finally, we note that the AG Opinion expresses a concern arising from the merger: that the merger will "produce incentives for the two 'independent' entities to engage in anticompetitive cross-subsidization that could occur in which Verizon ratepayers end up paying for purchases made by MCI at inflated prices."[81] The AG Opinion makes no recommendation on mitigation measures, but encourages the Commission to "scrutinize post-merger transactions between Verizon's regulated and non-regulated affiliates" to ensure that anti-competitive cross-subsidization does not occur.

7.3.1.7. Adopted Mitigation Conditions

For the reasons that we have discussed, we conclude that a number of conditions are necessary for approval of this application if we are to comply with the legislative mandate set forth in § 854. Accordingly, our order today imposes the following conditions on this transaction:

- Applicants shall flow through to their customers $103 million, or 50% of the $206 million net synergies attributable to California. (See discussion in Section 5.)

- Applicants shall maintain a five-year rate freeze for residential and small business basic local exchange services, including 1FR, 1MR, 1MB customers, and residential inside wire maintenance plans. (See discussion in Section 6.)

- Applicants shall for five years make these basic services available on a stand-alone basis, separately list the service in web sites and through bill inserts, and retain a pricing option for long distance

[81] Advisory Opinion, p. 24.

calling with no minimum monthly fee. (See discussion in Section 6.)

- Applicants shall report to the Commission one year after the effective date of this decision on the impact of employee layoffs on both union and non-union employees in the state of California. (See discussion in Section 7(d).)

- Verizon California shall continue to increase the supplier diversity goal for minority business enterprises from the current 15% to a minimum of 20% by the year 2010, and it shall make a good faith effort to commit $200,000 per year in development costs for five years to enhance an internal infrastructure supporting its diversity goal. (See discussion in Section 8.)

- In addition to synergy benefits, Verizon California shall increase its corporate philanthropy over the next five years by an additional $20 million above current levels, with a good faith effort to maintain the aggregate contributions to minorities and underserved communities in a manner consistent with its past practice. (See discussion in Section 8.)

- Applicants shall make stand-alone DSL service for high-speed Internet access available to consumers, and the DSL shall be based on industry standards to be compatible with competing providers' VoIP and other advanced services. (See discussion in Section 9.)

- Verizon shall be required for five years to allow any CLEC to adopt in California any agreement (except for state-specific prices and performance schedules) that Verizon has negotiated in any other state or any provision (or set of interrelated provisions) that Verizon has included in an agreement as the result of arbitration in California. We adopt this requirement because CALTEL has made a persuasive showing that this "opt-in" requirement is necessary to safeguard competition after the elimination of MCI and AT&T as competing carriers. (See discussion in Section 6.1.)

- We adopt a rate freeze on intrastate special access rates for both Verizon and MCI for a five-year period as a mitigation against excessive rate increases. We adopt this requirement on the recommendation of CALTEL and other parties.

- We adopt the recommendation of Internet service providers that Applicants agree to honor all of their existing Internet peering arrangements and to offer extensions, if requested by a carrier, at existing terms, conditions and prices. This condition shall remain in effect for a five-year period from the effective date of this decision. We conclude that this peering condition is necessary to support our finding that the merger is not anticompetitive. (See discussion at Section 6.2(c).

8. The Settlement Between Greenlining, LIF, and Applicants

Greenlining, LIF, and Applicants entered into a settlement agreement regarding the issues raised by Greenlining and LIF in this proceeding. The terms of the proposed settlement were first provided to parties and the Commission concurrently with opening briefs (attached as Exhibit A to the Greenlining and LIF briefs). The settlement provides a set of commitments by Applicants that purport to satisfy the requirements of §§ 854(b) and (c) relating to net benefits to consumers, including underserved communities.

The three main commitments presented in the settlement are:

- An increase in philanthropy from Applicants' current level of philanthropic giving by an additional $4 million for five years beginning the year after the merger;
- Supplier diversity commitments of 20% by 2010; and
- Leadership participation in the creation of a statewide Broadband Task Force to address California's digital divide and provide a forum for collaboration among state agencies, community technology centers, the private sector, major charitable foundations, non-profits and others to address issues affecting lack of technology access for many of California's poor and other underserved populations.

Greenlining and LIF believe that because Applicants' commitment is part of a long-term strategic plan, it is likely to have a greater impact than dollars committed by government, most foundations, or by corporations without long-term philanthropic commitments. Greenlining and LIF argue that the additional philanthropic commitments constitute a § 854(b) benefit.

ORA and TURN argue that the Commission should not approve this settlement at this time because the settlement has not been subject to scrutiny by other parties as required by the Commission's Rules of Practice and Procedure. The settlement proposes to resolve issues now that ORA and TURN have asked to be deferred to a subsequent phase of this proceeding, after the total amount of shared benefits has been determined.

The Commission's Rules require that all parties have an opportunity to review and comment on settlements. Rule 51.1(b) requires that prior to the signing of a stipulation or settlement, the settling parties shall convene at least one conference with notice and opportunity to participate provided to all parties for the purpose of discussing stipulations and settlements in a given proceeding. Notice served in accordance with Rules 2.3 and 2.3.1 of the date, time, and place shall be furnished at least seven days in advance to all parties to the proceeding.

These requirements have not been met. The Rules also provide for an opportunity to comment on the settlement. ORA believes this comment process should occur in a second phase of this proceeding, once the amount of economic benefits to be shared with ratepayers has been established.

In its Opening Brief, Greenlining asks that the additional amounts of corporate philanthropy required under the settlement be credited against any § 854(b) benefits allocated by the Commission. Greenlining asserts that allocating these benefits in accordance with the settlement agreement will be more beneficial than making refunds to customers. ORA does not believe the settlement is clear as to what extent ratepayers would actually benefit. The settlement would establish a broadband taskforce, yet such a body is already contemplated by the Commission's recent rulemaking on advanced technologies, R.03-04-003. In that proceeding, the Commission issued a broadband report which, among other things, made clear its expectations that the ILECs would play an active role in its efforts.[82]. It is unclear what additional effort or value this portion of the settlement represents as compared to the status quo.

The settlement also calls for Applicants to increase their charitable giving, using monies that otherwise would be shared as merger benefits. Verizon's dues, donations and advocacy expenses have traditionally been booked "below the line" in accordance with established ratemaking theory. *(GTE California* (*NRF Review*) (1994) 55 CPUC2d 1, 41-42.) Provisions on service quality also seem to duplicate the Commission's requirements.

The provision of the settlement relating to philanthropy also protects shareholders by affirming that Verizon will have no settlement obligation should the merger not go through, or if the merger only gains approval subject to conditions that increase § 854(b)(2) credits beyond the amount envisioned in the settlement. Presumably, if any conditions are imposed that Applicants view as exceeding the settlement amounts, any funding of philanthropy commitments under the settlement would be charged to ratepayers. Yet, the Commission has repeatedly affirmed its prohibition on using ratepayer funds to cover expenses associated with philanthropy.

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[82] D.05-05-013, Appendix A, p. 77.

Both ORA and TURN have asked that the Commission consider how § 854(b) benefits will be allocated *after* determining the amount of economic benefits that will be allocated to ratepayers. ORA has not argued that these benefits must necessarily be returned to ratepayers in the form of a refund or surcredit, but has asked the Commission to consider how to fund several of the conditions that ORA has proposed or supported.

While the settlement extracts certain concessions from Applicants relating to philanthropy, diversity, and bridging the digital divide, other substantive and procedural defects prevent us from adopting the settlement in its present form. We agree with TURN and ORA that because settling parties failed to convene a settlement conference pursuant to Rule 51.1(b), the settlement is not ripe for Commission adoption.

Moreover, we have already determined the benefits that apply as a result of the synergy calculations discussed previously in this decision. We have also adopted other various mitigating conditions with which Applicants disagree. The settlement presumably would permit Applicants to abandon all of their commitments under the settlement if they unilaterally deem other requirements of this decision to be onerous. Such a condition would unacceptably foreclose the Commission from carrying out its responsibilities to make sure the proposed merger is in the public interest.

While the settlement cannot be adopted in the form that sponsoring parties request, we do find that elements of the settlement contain useful information, particularly in the context of the larger body of testimony and evidence that parties have presented concerning diversity, charitable giving, and bridging the digital divide. Accordingly, we shall require Applicants to agree to the commitments set forth below in order to satisfy the public interest requirements under § 854(c.) The funds required to meet these commitments under § 854(c) are in addition to the synergy net benefits calculated pursuant to § 854(b), as discussed above.

With respect to supplier diversity, we shall require as a condition of the merger that Applicants commit to the minimum diversity goals set forth in the settlement. We conclude that these diversity goals will be instrumental in satisfying the requirements of § 854(c)

With respect to charitable giving, we shall adopt as a condition of the merger that Verizon commit to the level of $20 million in additional philanthropic giving as discussed in the proposed settlement.

The question remains as to how this finite pool of available funds can best be allocated among the needs of these different interests. Now that the total amount of available funds to address § 854(c)(6) concerns has been determined, parties will be in a more informed position to present proposals as to how these funds should be allocated. We therefore solicit comments from parties concerning more specific measures concerning how the philanthropic funds should be allocated among these various interest groups, with particular attention to the specific needs of disabled, low-income, minorities, and other elements of the underserved community, as part of our consideration of the distribution of net benefits. As part of their comments, parties should address the extent to which the funds should be allocated in the form of grants to community-based foundations. Comments shall be due 20 calendar days after the effective date of this decision. Following review of those comments, we shall determine further direction regarding the use and distribution of the additional Verizon philanthropy commitments.

We find that this condition will help to ensure the merger will benefit local communities and economies in accordance with § 854(c), while fulfilling this Commission's mandate to pursue widespread availability of high-quality telecommunications services to all Californians under § 709 of the Public Utilities Code.

9. Stand-Alone DSL

Verizon bundles DSL with its wireline service and is not currently obligated to offer a stand-alone DSL product. Stand-alone DSL refers to the offering of DSL, for high speed Internet access, to a customer without also requiring the customer to buy additional services, such as traditional local phone service or VoIP service, from the same provider.

ORA, Qwest, and Level 3 propose that as a condition of approving the merger, stand-alone DSL be provided by the merging entities, and that DSL be based on industry standards to be compatible with competing providers' VoIP and other advanced services. By tying together DSL service with its voice services, Verizon discourages consumers from using VoIP competitors. Verizon has not had a mass market VoIP product, but in the past has used this required DSL bundling as means to discourage Verizon broadband customer migration to primary line VoIP service, by requiring a circuit-switched voice line purchase as a condition of getting and keeping Verizon broadband.

Some consumers prefer to buy packages of multiple services, while others prefer to buy individual services from different providers. Competitively priced individual offerings from different providers, however, allow competitors to compete on a service-by-service basis and, as a result, consumers benefit from more choices and better prices.

Verizon currently provides DSL service to subscribers in California only where the customer also subscribes to Verizon voice service. Both the DSL and voice service is provided over a single cooper loop. Applicants claim that requiring Verizon California to offer stand-alone DSL would be in violation of federal authority that a loop constitutes a single network element that is not subject to further unbundling.

Applicants claim there are numerous competitive alternatives to DSL, including ubiquitous cable modems, wireless broadband and other technologies, such that DSL unbundling is not necessary. Applicants argue that mandatory unbundling of DSL would actually impair competition by producing disparate regulatory treatment of the various modes of broadband connections.

We agree that in order to mitigate Verizon's market power in this area, Verizon should be required to offer DSL on a stand-alone basis, without tying DSL to a requirement also to take Verizon voice service. We disagree with Applicants' claim that the requirement for Verizon to offer DSL on a stand-alone basis constitutes a violation of federal authority that the low frequency portion of the local loop is not subject to further unbundling.

We conclude that Verizon's practice of refusing to offer stand-alone DSL harms competition by making it more difficult for competitors to provide voice service to customers subscribing to broadband Internet access over Verizon's DSL facilities. The potential for this practice to harm competition will be amplified with the merger. We therefore adopt as a condition of the merger that Verizon must offer DSL to consumers on a stand-alone basis without being tied to Verizon voice service. Customers will then have the option of purchasing local voice service, including VoIP, from a competing carrier.

10. Conclusion

In summary, we find that the proposed merger of the parent companies of Applicants and resulting change of control is in the public interest pursuant to § 854, provided Applicants adopt the mitigation conditions set forth in our order. In addition, in the course of our § 854(b) and § 854(c) examination and our examination of the competitive impacts of this merger, we have reviewed proposals recommended by other parties, adopted some of them, and find that the transaction as proposed and as modified herein serves the public interest.

11. Comments on Draft Decision

The Draft Alternate Decision of Commissioner Geoffrey F. Brown in this matter was mailed to the parties in accordance with Pub. Util. Code § 311(g) and Rule 77.6(d) of the Rules of Practice and Procedure.[83] Comments on this Alternate Draft Decision of Commissioner Brown were filed by Applicants, ORA, TURN, Qwest, Cox, CALTEL, CISPA, Latino Issues Forum, DRA and Earthlink. Applicants and Latino Issues Forum oppose the Alternate Draft Decision, urging the Commission instead to adopt the Proposed Decision of Commissioners Kennedy and Peevey. All other parties urge adoption of the Alternate Draft Decision, primarily on grounds that it applies all of the provisions of Pub. Util. Code § 854 in evaluating the merger transaction, but most of these parties also urge that the Alternate Decision be modified to add additional conditions in approving the merger. A number of parties, including Applicants and TURN, to some extent reargue positions taken in briefs, and

[83] *See* Pub. Util. Code § 311(g), and Rule 77.

those arguments are accorded little or no weight. (*See* Rule 77.3 of the Rules of Practice and Procedure.)

Applicants in their comments continue to argue that because the transaction here is between holding companies of Verizon and MCI, no "telephone utility" is a "party" to the transaction, and therefore § 854(b) cannot by its terms apply to this transaction. As we have explained in this decision, the substance of this transaction will have a significant impact on California public utilities and their customers. The Commission has broad statutory powers to ensure that ratepayers are not deprived of the benefit of transactions where the utility (in this case, Verizon California and the MCI subsidiaries) would have been directly involved but for the holding company structure that Applicants decided to employ. Latino Issues Forum supports the arguments of Applicants and contends that its proposed settlement agreement with Applicants provides greater support for low-income and limited-English ratepayers than any alternative available to the Commission.

ORA supports the Alternate Draft Decision, with some modifications, "because it is based on the record and fairly resolves the majority of disputed issues in this proceeding…[and] it correctly analyzes the legal issues presented in this case –specifically, the applicability of PU Code § 854(b) and (c)." (ORA Comments, at 1-2.) While it contends that the Alternate is "more legally sound" and better addresses competitive concerns than the Kennedy/Peevey Proposed Decision, ORA urges that the Alternate be modified to require third-party monitoring of continuing competitive conditions and a "first-priority" requirement of the parent company for the benefit of Verizon California, similar to conditions adopted in the Proposed Decision in the SBC/AT&T merger proceeding.

Cox supports the Alternate Draft Decision, arguing that the Kennedy/Peevey Draft Decision would "overturn" the Commission 1997 decision in SBC-Telesis and render § 854 "meaningless." (Cox Comments, at 5.) While noting that the Brown Alternate adopts two of the three conditions urged by Cox for an opt-in to interconnection agreements, Cox urges that a third condition (requiring Verizon to transit traffic at TELRCI-based rates) should also be adopted based on the unrebutted testimony of its expert witness.

Similar support for the Alternate Draft Decision is voiced by CALTEL, Earthlink and DRA, but CALTEL regards the failure to discuss a wholesale price caps mechanism constitutes "error," (CALTEL Comments, at 2) and Earthlink urges that the Commission make it clear that all customers of Verizon DSL services should be entitled to unfettered stand-alone DSL service. DRA would prefer that the Draft Decision provide further discussion of the effect of the proposed merger on the needs of people with disabilities.

TURN "wholeheartedly supports" the Alternate Draft Decision, but only if the Commission makes numerous amendments based on TURN's view of the record. First, TURN urges a finding that the merger will produce no short-term economic benefits to ratepayers, thus providing the foundation for the proposed five-year freeze on basic rates that the Alternate Draft Decision adopts. Second, TURN recommends that the Commission adopt a long-term view of merger synergies in perpetuity, just as it believes Applicants did in persuading shareholders to approve the merger. TURN contends that the merger will significantly increase concentration in the mass market, in contrast to the Alternate Decision's conclusion that the market already is highly concentrated and will not significantly change as a result of the merger. Like ORA, TURN urges a provision for monitoring market concentration in the future, and it proposes corrections in the analyses of long-distance competition, effects on the enterprise market and the financial condition of the merging utilities.

Qwest urges adoption of the Alternate Draft Decision, but it also urges that additional merger conditions be adopted to prevent competitive harm in the market for special access. Specifically, Qwest would have the Commission analyze and augment proposed FCC conditions addressing special access that were recently announced in an FCC press release. Similarly, while CISPA supports the Alternate Draft Decision, it urges modifications to strengthen and provide enforcement for conditions requiring stand-alone DSL access.

We have carefully considered the comments of all parties, and we find merit in a number of the recommendations. Our principal tasks, however, are to weigh the public interest in the proposed merger transaction and, as Applicants maintain, to impose conditions only when we find that they are necessary to ensure that the competitive effects of the transaction do not adversely affect the public interest. (*See* Pub. Util. Code §§ 854(b) and (c).) In our judgment, many of the additional conditions proposed by parties are not justified by the record that we have before us, and a number of what we would deem new factual assertions cannot be considered because they are "untested by cross-examination," as required by Rule 77.3 Nevertheless, pursuant to Rule 77.3, six of the commenting parties have attached appendices to their comments setting forth proposed changes and corrections in our findings of fact and conclusions of law, and we have made changes in the Alternate Draft Decision, where appropriate, based on those recommended changes.

12. Assignment of Proceeding

Susan P. Kennedy is the Assigned Commissioner and Principal Hearing Officer for this proceeding. ALJ Glen Walker is assigned to this proceeding.

This Alternative Draft Decision was prepared by Commissioner Geoffrey F. Brown. ALJ Walker assisted in the preparation.

Findings of Fact

1. Applicants seek approval of a transfer of control of MCI's California subsidiaries to Verizon that will occur indirectly as a result of a transaction between holding companies for Verizon and MCI.

2. As a result of the merger between Verizon and MCI, Applicants intend to strengthen the financial position of the combined company and improve its competitive position by combining complementary strengths and skills.

3. The California Attorney General filed his Advisory Opinion in this matter on September 16, 2005.

4. The Commission examines merger, acquisition, or control activities on a case-by-case basis to determine the applicability of § 854.

5. Applicants agree that § 854(a) applies to this transaction, but they challenge the applicability of §§ 854(b) and (c).

6. Although the proposed merger transaction is technically structured as a merger between the holding companies of Verizon and MCI, the practical result of the merger will have effects on the California utilities that are owned by Verizon and MCI.

7. In determining whether Verizon California is a party within the meaning of Section 854, the Commission focuses on substance rather than form.

8. It would elevate form over substance to find that §§ 854(b) and (c) do not apply to this transaction merely because Applicants designed the merger using a holding company structure.

9. It would elevate form over substance to conclude that the Legislature was more concerned with competition if the utility was a party to the transaction

absent the holding company structure, but was less concerned about competition when a holding company was involved.

10. At the direction of the Assigned Commissioner, Applicants produced a calculation of net synergy benefits to California consumers on a discounted net present value basis, assuming the Commission applies § 854(b) to this transaction over Applicants' objections.

11. Applicants' calculated $6.6 million in net benefits to California consumers assuming the Commission were to find that § 854(b) applies. The $6.6 million represents 50% of the discounted net present value of Applicants' four-year forecast of merger synergies attributable to Verizon California only, or approximately 1/10 of 1% of the total corporate synergies that Applicants forecast from the Verizon/MCI merger.

12. ORA and TURN performed separate calculations using Applicants' synergies model as a starting point. ORA produced a calculation of at least $206 million in applicable net synergy benefits in California on a discounted net present value basis. TURN produced a calculation of approximately $731.4 million. ORA and TURN each propose allocating at least 50% of the calculated net benefits to consumers.

13. Two of the largest factors accounting for the difference between the ORA/TURN calculation of synergies versus that of Applicants are: (1) inclusion of MCI operations in both the total benefits and the California allocation factor and (2) extending the measurement period to incorporate the full period over which total corporate benefits were considered as a basis for shareholders' evaluation of the merger.

14. Based upon the calculations of synergies performed by Applicants, modified to incorporate certain adjustments made by ORA/TURN, the total net

synergy benefits reasonably attributable to California is $206 million on a discounted net present value basis under the provisions of Section 854(b).

15. A $103 million allocation of net benefits to California consumers represents a 50% share of total benefits of $206 million attributable to California, reflecting a long-range forecast of approximately eight years plus a terminal value in perpetuity, as calculated by ORA.

16. The adopted net benefit amount incorporates ORA's recommendation to reallocate offsetting costs to implement the merger so that a pro rata share are assigned beyond the period during which ratepayers share in the forecasted synergies.

17. The Attorney General's Advisory Opinion concluded that the merger will not adversely affect competition in California telecommunications markets with the exception of the market for special access.

18. By focusing its analysis on facilities-based competition, the Attorney General's Advisory Opinion did not fully address the effects of the merger on the overall telecommunications markets in which Verizon and MCI compete. In this respect, the testimony presented by expert witnesses on competitive impacts of the merger provided a more complete analysis with respect to the range of relevant markets.

19. In D.91-05-028, the Commission set forth analytical precedents for interpreting whether a party's proposal "adversely affects competition" within the meaning of § 854(b)(3). The Commission held that precedent developed under Section 7 of the Clayton Act provides a framework for analyzing the competitive effects under § 854(b)(3).

20. The goal of analyzing the competitive effects of the merger is to protect consumers by preventing transactions likely to result in increased prices or

reduced output. Mergers can harm consumers when they cause structural changes to the marketplace that increase a firm's ability to exercise market power, defined as the ability to affect prices or reduce output of the industry.

21. Under traditional market analysis, the market power resulting from the merger of two competitors is usually measured in terms of concentration, or market shared. This is a statistical analysis using the Herfinhdahl-Herschman Index (HHI) which calculates the sum of the squares of each firm's market share.

22. The analysis of market share and HHI measures is a necessary starting point for analyzing market power due to a merger, after which additional indicators of prospective competition are properly considered.

23. Traditionally, the competitive effects of a proposed merger are analyzed by identifying the relevant product markets affected by the merger. The geographic scope of the market, the area in which the sellers compete and in which buyers can practicably turn for supply are identified as part of this analysis.

24. The relevant markets for purposes of analyzing the competitive effects of this merger include retail markets (i.e., mass market, medium and large enterprise customers) and wholesale markets.

25. Applicants did not perform an analysis of market concentration relating to this merger, either in the aggregate or for individual markets, since they believe that only forward-looking indicators of competition are meaningful in assessing the Verizon/MCI merger.

26. ORA and TURN witnesses presented calculations of the HHI with respect to individual market segments. These analyses show that the HHI was already highly concentrated before the merger, and becomes more highly concentrated as a result of the MCI acquisition.

27. Although the mass market is already highly concentrated, Verizon's acquisition of MCI will not significantly change the degree of mass market concentration since MCI had already ceased actively marketing to this sector before entering into the merger. However, the inability of the two largest competitive LECs – MCI and AT&T – to compete with incumbent LECs for mass market customers creates a pessimistic outlook for smaller rival carriers, indicating that the mass market will become even more highly concentrated going forward.

28. Mass market customers could be adversely affected by the merger to the extent that merger-related costs could increase their utility bills, or utility resources could be diverted to reduce the level or quality of service offered to them.

29. Verizon and MCI chose to merge rather than to compete against each other through facilities-based expansion of their respective networks.

30. Given the failure of MCI to succeed as an independent competitor pursuing facilities-based expansion, the prospects for other carriers with less financial resources to compete successfully against the post-merger Verizon is called into question.

31. In the retail business markets and in wholesale markets in which Verizon and MCI compete, the measures of market concentration measured by the HHI indicate a material increase in Verizon's market power from the merger.

32. Evidence presented concerning forward-looking measures of competition in sectors other than the mass market does not paint a picture of a robustly competitive market today or in the immediate future.

33. Although some competition from intermodal sources such as cable, VoIP, and wireless technologies exists within certain sectors of the Verizon California

service territory, such competition is not sufficiently developed in all relevant markets today to avoid the need for conditions to mitigate Verizon's increased market power from the merger.

34. Although their marketing focus differs to some degree, Verizon and MCI have been competing head-to-head for enterprise business customers throughout the Verizon footprint.

35. Certain proposed measures, as identified below, will mitigate the competitive harm that could otherwise result from the proposed merger.

36. Capping UNE rates in the manner proposed by CALTEL could conflict with broader FCC "just-and-reasonable" principles relating to the pricing of such UNEs.

37. CALTEL's proposal to permit carriers to opt in on any agreement negotiated by Verizon in another state or any provision(s) arbitrated in California is an appropriate mitigation measure.

38. Verizon possesses significant market power in the provision of special access services in California.

39. MCI has played a pivotal role in disciplining the rates, terms, and conditions under which Verizon offers special access generally, both as an alternative source of supply to other competitors and by its negotiating leverage in obtaining more favorable terms and rates.

40. Absent mitigating conditions, the removal of MCI as a competitor in the special access market will give Verizon additional opportunities to leverage its market power against competitors to the detriment of consumers.

41. Parties' proposed condition to permit a "fresh look" period following the close of the merger has not been shown to be justified except for the limited

purpose of allowing carriers to accept the same package of terms and rates negotiated between affiliates of Verizon.

42. It is reasonable as a mitigation measure in response to MCI's elimination as a competitor in the short-haul market, to require that Verizon extend its existing transport agreements for a five-year period at the same rates, terms and conditions.

43. Level 3 has not shown that Commission intervention is warranted in calling for the exchange of VoIP traffic at reciprocal compensation rates.

44. Verizon's practice of refusing to offer stand-alone DSL service harms competition by making it more difficult for competitors to provide voice service to customers subscribing to broadband Internet access over Verizon's DSL facilities. The potential harm from this practice will increase through acquisition of MCI.

45. A reasonable merger mitigation measure is to require SBC to offer DSL on a stand-alone basis.

46. With the conditions adopted in this decision, the merger will improve the financial condition of Verizon and MCI.

47. The merger will maintain or improve the quality of management of the combined company.

48. Service quality will be maintained or improved as a result of the merger, with the service quality conditions adopted in the ordering paragraphs below.

49. The merger will be fair and reasonable to affected public utility shareholders, as reflected by the approval of the merger by Verizon and MCI shareholders.

50. With the adoption of conditions set forth in this order, the Commission will preserve its jurisdiction and ability to regulate and audit public utility operations in the state.

51. Subject to adoption of mitigating conditions relating to philanthropy, workplace diversity, and outreach to underserved segments of the community, as set forth in the ordering paragraphs below, the merger will be beneficial on an overall basis to state and local economies and to the communities served by the combined company.

52. Applicants entered into a settlement with Greenlining and LIF addressing the issues of net benefits to consumers, supplier diversity issues, and corporate philanthropic commitments to local communities.

53. While the terms of the settlement would result in greater commitments than Applicants otherwise propose to offer, the settlement, in total, is procedurally defective and contains unacceptable restrictions that would prevent the Commission from adopting it in its present form consistent with § 854.

54. A reasonable measure to assure that the proposed merger is in the public interest of local communities, including the underserved segments thereof, Verizon should be required to commit to philanthropic contributions in the amount of $20 million over a five-year period.

Conclusions of Law

1. Section 854(e) requires that the Applicants have the burden of proof by a preponderance of evidence to demonstrate that the requirements of §§ 854(b) and (c) are met.

2. In order to determine whether § 854(b) applies to this application, the actual language of the statute should first be examined. In examining the statute's language, decisionmakers should give the words of the statute their

ordinary, everyday meaning. If the meaning is without ambiguity, doubt, or uncertainty, then the language controls. Only if the meaning of the words is not clear should decisionmakers take the second step and refer to the legislative history.

3. The plain language of § 854(b) is clear, and applies where a utility of a specified financial size is a party to the proposed transaction.

4. Because the substance of the transaction should take precedence over its mere form, Verizon California and MCI California subsidiaries should both be considered as parties to this transaction in applying § 854(b).

5. Past mergers of telecommunications companies that were granted an exemption from review under §§ 854(b) and (c) are not analogous precedents for this transaction, which involves consolidating the assets of the state's second largest ILEC and one of the country's major CLECs.

6. Section 854(b) and (c) apply to this transaction.

7. Section 854(b) requires the Commission to allocate to ratepayers certain forecasted benefits that accrue as a result of the merger.

8. Section 854(b) requires that ratepayers be allocated a minimum 50% of California short-term and long-term economic benefits accruing as a result of the merger.

9. A reasonable estimate of long-term economic synergies accruing to California consumers under the merger consistent with § 854(b) is $103 million on a discounted net present value basis representing 50% of the total California synergies of $206 million.

10. The Commission should require as a condition of the merger that Applicants pass on to consumers the § 854(b) economic benefits associated with the merger as quantified in this decision.

11. The specific distribution and/or utilization of the § 854(b) net benefits among various consumer interests should be addressed in a subsequent order following opportunity for parties to file comments.

12. Section 854(b)(3) requires the Commission to find that Applicants' proposal does not adversely affect competition.

13. The Commission must determine the appropriate weight to give the Attorney General's Advisory Opinion, also taking into account the substantive evidence on competitive harm and proposed mitigation measures presented through expert witness testimony in the proceeding.

14. The proposed merger should not have an adverse effect on competition within the meaning of § 854 if specified conditions are adopted.

15. In carrying out its obligation to evaluate potential adverse effects under § 854, the Commission should examine all relevant effects on California consumers, even if a particular impact may involve services that are regulated by a federal agency.

16. In order to meet the § 854(b) standard that the proposed merger does not have an adverse effect on competition, conditions should be imposed to mitigate competitive harms that would otherwise result from the transaction.

17. With the imposition of the conditions set forth in the ordering paragraphs, the proposed transaction meets the requirements of § 854 and should be approved subject to those conditions.

O R D E R

IT IS ORDERED that:

1. The application of Verizon Communications Inc. (Verizon) and MCI, Inc. (MCI) (collectively, Applicants) is granted, subject to the conditions set forth herein.

2. Applicants shall notify the Commission in writing when the merger that is the subject of this application has been consummated. The written notice shall be delivered to the Commission within five business days of the effective date of the merger.

3. Verizon shall maintain a cap on basic residential and small business local exchange services, including 1 FR, 1 MR, 1 MB, and residential inside wire maintenance plans, to continue for a period of five years from the effective date of this decision. These services shall be made available to consumers on a stand-alone basis without any requirement to purchase other bundled services. The services shall be listed separately in Verizon phone directories and in any advertising on web sites or through bill inserts. Verizon shall retain a pricing option for California-jurisdictional long distance calling that does not have a minimum monthly fee.

4. Verizon shall implement appropriate measures to distribute Section 854(b) California synergy benefits in the amount of $103 million. The implementation method shall be determined through a subsequent Commission order following opportunity for parties to comment on the manner in which the Section 854(b) net benefits should be distributed. Comments on this issue shall be filed 20 calendar days from the effective date of this decision.

5. As a condition of Commission approval, Verizon shall implement the following measures to remain in effect for a five-year period from the effective date of this order.

   a. Verizon shall be required to honor existing Internet peering arrangements and to offer extensions, if requested, for up to five years.

   b. Verizon shall be required to allow any competitive local exchange carrier (CLEC) to adopt in California any agreement that Verizon has negotiated in any other state (except for state-specific prices and performance standards), or any provision or set of interrelated provisions that Verizon has included in an agreement as the result of arbitration in California.

   c. Verizon shall offer digital subscriber line (DSL) service on a stand-alone basis without being tied to other Verizon services.

6. Applicants shall agree to the following conditions in order to satisfy the criteria under Section 854(c).

   a. Applicants shall agree to an increased cumulative philanthropy commitment of $20 million over a five-year period. A more specific determination of how the philanthropy funds should be distributed, either among the affected groups, or through grants to community-based foundations shall be made following opportunity for parties to comment. Comments on the issue of the appropriate distribution and/or utilization of the philanthropy funds shall be filed 20 calendar days from the effective date of this decision.

   b. As a condition of the merger, Applicants shall report to the Commission one year after the effective date of this decision on the impact of employee layoffs on union and non-union employees in the state of California.

7. Applicants shall file written notice with the Commission in this proceeding, served on all parties to this proceeding, of their agreement, evidenced by a resolution of their respective boards of directors, duly authenticated by a secretary or assistant secretary, to the conditions set forth in this decision. Failure of Applicants to file such notice pursuant to this order within 60 days of the effective date of this decision shall result in the lapse of the authority granted in this decision.

This order is effective today.

Dated ____________________, at San Francisco, California.