August 1, 2005

Jaclyn A. Brilling, Secretary
New York State Department of Public Service
3 Empire Plaza
Albany, NY 12223-1350

Re: CASE 05-C-0237-Joint Petition of Verizon New York Inc. and MCI, Inc. for a Declaratory Ruling Disclaiming Jurisdiction over or in the Alternative for Approval of Agreement and Plan of Merger.

Re: CASE 05-C-0242- Joint Petition of SBC Communications. Inc, AT&T Corporation, together with its Certificated New York Subsidiaries, for Approval of Merger.

Dear Secretary Brilling,

Please accept these comments in Case 05-C-0237 regarding the proposed merger of Verizon New York Inc. (Verizon) and MCI, Inc. (MCI), and in Case 05-C-0242 regarding the proposed merger of SBC Communications (SBC) and AT&T Corporation (AT&T). The Commission issued notice on July 6, 2005 soliciting comments on a staff white paper.[1] These comments pertain to the proposed merger of Verizon and MCI and the issues relating to Case 05-C-0242 Joint Petition of SBC Communications Inc., AT&T Corporation, together with its Certified New York Subsidiaries, for Approval of Merger. The Department of Public Service Staff White Paper (White Paper) dated July

[1] CASE 05-C-0237 -Joint Petition of Verizon New York Inc. and MCI, Inc. for a Declaratory Ruling Disclaiming Jurisdiction over or in the Alternative for Approval of Agreement and Plan of Merger. State of New York Public Service Commission "Notice Soliciting Comments on Staff White Paper," Issued July 6, 2005.

6, 2005 will be the basis of this presentation.[2] The comments presented here conclude that:

1. Due to the Verizon/MCI merger's anti-competitive aspects as demonstrated in the HHI analysis, the remedies proposed need to be structured to ensure that competition increases. This regulatory task will be, however, extremely difficult to accomplish.

2. The petitioners in the Verizon/MCI proposed merger have failed to provide adequate cost and synergy information, financial and business business-risk information, and other key materials that must be examined before the Commission decides on the merits of the merger. A utility rate case-type analysis is needed in this proceeding before the Commission can decide the merits of the merger.

3. The SBC/AT&T merger can be accepted as outlined in the Staff White Paper.

Introduction

It is clear that the New York State Public Service Commission has the power under Section 100 of the Public Service Law to review proposed mergers and to implement conditions to protect the public interest when necessary.[3] Recent Commission decisions have illustrated the Commission's power to oversee and approve conditions on mergers.[4] Additionally, the Commission has a long-standing requirement under Section 100 of the Public Service Law to decide that the merger is "in the public interest." The Commission must decide that the merger is in the public interest as indicated by the specific language in Public Service Law Section 100:

[2] See "Department of Public Service Staff White Paper" dated July 6, 2005 in Cases 05-C-0237 and 05-C-0242.

[3] PSL Section 100.

[4] Case 96-C-0603 et. al., NYNEX Corporation and Bell Atlantic Corporation-Merger, Opinion 97-8 issued May 30, 1997; and Case 98-C-1443, Petition of Bell Atlantic for Approval of Agreement and Plan of Merger with GTE Corporation, Issued and Effective August 12, 1999.

> "…No consent shall be given by the Commission to the acquisition of any stock in accordance with this section unless it shall have been shown that such acquisition is in the public interest;…"

Also, the Commission clearly has the authority to decide the merits of the merger free from argument related to the Interstate Commerce Clause of the United States Constitution.[5]

The Staff White Paper should be commended for its comprehensiveness in discussing the competitive aspects of the proposed merger and the remedies needed to avoid the lack of competitiveness. The White Paper also discusses some financial and accounting protections for consumers. The comments presented below discuss four areas:

1. While the use of the HHI indices provide some information about the competitive concerns of the proposed Verizon/MCI merger, the remedies proposed in the Mass Market area must be appropriately structured to ensure that they promote competition. This is an extremely difficult regulatory task to accomplish.

2. The petitioners in the Verizon/MCI merger have failed to provide adequate cost and business/financial risk information in this proceeding to allow the Commission or the parties to the proceeding to address the cost savings, synergies, and rate and risk impacts of the proposed merger.

3. The Staff White Paper provided adequate assurances to the public concerning the SBC/AT&T merger and should be adopted in total.

4. Summary and Conclusions

Each of these areas are addressed in turn. While the complex issues associated with the four merging corporations present a vast array of issues as outlined in the Staff White Paper, we should initiate any review of the issues by examining the mission statement of the Department of Public Service. It reads:

[5] See Section 8 of the U.S. Constitution; and Opinion 97-8 pp. 9-12.

Mission Statement

> The mission of the New York State Department of Public Service is to ensure safe, secure, and reliable access to energy, telecommunications, and water services for New York State's citizens and businesses. With an emphasis on promoting competitive markets, the Department seeks to maximize customer choice and value for these services by stimulating innovation, strategic investment, and the use of resources in an efficient and environmentally responsible manner. Where competition is not present or viable, the Department will exercise its regulatory authority judiciously to ensure equitable rates and high quality service.[6]

The concepts of customer choice, competitive markets, innovation, equitable rates, and high-quality service are some of the key elements in the mission statement. The Staff White Paper should be considered as an elaborate attempt by the Department of Public Service to achieve its mission by reviewing the critical aspects of the proposed mergers. The White Paper goes to great length to propose solutions to help enhance the possibility of the two mergers. A fair and careful review of the issues presented by Staff, however, can lead to some basic conclusions. First, the Commission should reject the proposed Verizon/MCI merger as presented unless it fully develops workable remedies that will allow competition to spread. Much additional cost and synergy information must be presented to Staff in this proceeding and an appropriate financial and business risk assessment must be conducted.

The best way to assess these issues is in a traditional utility-type rate proceeding that can still be conducted in this case to study the cost of the merger, synergy issues, and business and financial risk issues. It is a mistake for the Commission to decide the merits of the merger before this critical analysis is completed. The strategy of deciding the merger and deferring much of the key public interest aspects of the case to a future

[6] See www.dps.state.ny.us/mission.html July 10, 2005.

Comp III proceeding is not in compliance with the specific public interest standard of Public Service Law Section 100.[7]

It is clear that in the NYNEX/Bell Atlantic merger the Commission conducted an extensive "PUBLIC INTEREST ANALYSIS" at pp. 17 to 32 of Commission Opinion 97-8. The analysis considered a wide rage of issues including:

1. General Public Interest Issues
2. Competition
3. Service Quality
4. Economic Impact
5. Impact of the Merger on Regulation
6. The Performance Regulatory Plan and Rates.[8]

Also, in the 1999 Bell Atlantic and GTE merger case the Commission found that the transaction was in the public interest in part because "… the estimated cost savings generated from the merger could be significant,…"[9] The Commission then found that "we invoked the reserve authority clause to ensure that a substantial portion of those merger savings benefit New York telecommunications consumers."[10] In the current case the synergy aspects and business and financial risks are so undeveloped in the

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[7] See Opinion 97-8 page 15. Also, see the activity in Case 05-C-0161, <u>Proceeding on Motion of the Commission to Examine Issues Related to the Transition to Intermodal Competition in the Provision of Telecommunications Services</u>.

[8] See Opinion 97-8, pp. 17-28 for the Commission's analysis of the six public interest areas.

[9] Case 98-C-1443, Petition of Bell Atlantic for Approval of Agreement and Plan of Merger with GTE Corporation, Issued and Effective August 12, 1999, p.9.

[10] Case 98-C-1443, Petition of Bell Atlantic for Approval of Agreement and Plan of Merger with GTE Corporation, Issued and Effective August 12, 1999, p. 9.

record that it is impossible to determine if the proposed merger is, in fact, in the public interest.

The Commission has a long history of making determinations that mergers and acquisitions are in the public interest. This is evident not only in the telecommunications sector, but in the energy area also. In the past seven years massive mergers and acquisitions have occurred in the energy related sectors in New York. These mergers have affected millions of consumers and have influenced electric and natural gas service in New York State. They have had complex accounting issues and the Commission found that the mergers were in the public interest after fully investigating the significant issues.[11]

In all of those proceedings the Commission took the time to conduct a careful review of the many complex issues to ensure that the transaction is in the public interest. Examples include Case 97-M-0567- Joint Petition of Long Island Lighting Company and The Brooklyn Union Gas Company for Authorization under Section 70 of the Public Service Law to Transfer Ownership to an Unregulated Holding Company and Other Related Approvals.[12] "Significant rate reductions" were established in the case before the public interest determination was made and a process to provide the cost savings to consumers was identified.[13]

In Case 98-M-0961 – Joint Petition of Consolidated Edison, Inc., Consolidated Edison Company of New York, Inc. and Orange and Rockland Utilities, Inc. for

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[11] Section 70 of the Public Service Law applies here.

[12] Case 97-M-0567 Joint Petition of Long Island Lighting Company and The Brooklyn Union Gas Company for Authorization under Section 70 of the Public Service Law to Transfer Ownership to an Unregulated Holding Company and Other Related Approvals. Opinion and Order Adopting Terms of Settlement Subject to Conditions and Changes, Issued and Effective April 14, 1998.

[13] Ibid., pp. 36-37.

Approval of a Certificate of Merger and Stock Acquisition, the Commission solved the synergy aspects of the merger before the public interest determination was made.[14] The Commission was able to cite immediate and tangible benefits for consumers including:

- Cost savings
- Rate reductions
- New programs
- Benefits from the combined operation.[15]

The Commission decided that the merger of New York State Electric & Gas Corporation and Rochester Gas and Electric is in the public interest during 2002.[16] The Commission in approving the merger cited synergy savings of $164.3 million and numerous rated reductions for consumers. The Commission provided a long list of other tangible merger benefits.[17]

The Commission's public interest determination in the case also resolved a number of complex accounting issues including the proper resolution of whether costs are "expensed, amortized, or depreciated' and whether the accounting for other pension and employee benefits (OPEB) funds is appropriate.[18] Other accounting issues

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[14] CASE 98-M-0961 – Joint Petition of Consolidated Edison, Inc., Consolidated Edison Company of New York, Inc. and Orange and Rockland Utilities, Inc. for Approval of a Certificate of Merger and Stock Acquisition, Issued and Effective April 2, 1999.

[15] Ibid., p. 22.

[16] See CASE 01-E-0359- Petition of New York State Electric & Gas Corporation for Approval of its Electric Price Protection Plan and CASE 01-M-0404- Joint Petition of Energy East Corporation, RGS Energy Group, Inc. New York State Electric & Gas Corporation, Rochester Gas and Electric Corporation and Eagle Merger Corp. for Approval of Merger and Stock Acquisition, Issued and Effective February 27, 2002.

[17] Ibid., pp. 4-8.

[18] Ibid., pp. 13-14.

concerned the possible acceleration of the amortization of regulatory asset costs, deferral of items such as storm expense costs, and the Power Partner program accounting issues.[19] This can be contrasted to the situation in this case where accounting issues such as the value of MCI's assets are left, essentially undetermined.

The Commission must decide the public interest aspects of the proposed Verizon/MCI merger in this proceeding before any decision can be made on the merger. The SBC/AT&T merger can be approved since the Staff White Paper has conducted a through analysis of it and they offered no major concerns to reject the merger.

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Section 1: While the use of the HHI indices provide some information about the competitive concerns of the proposed Verizon/MCI merger, the remedies proposed in the Mass Market area must be appropriately structured to ensure that they promote competition. This is an extremely difficult regulatory task to accomplish.

The Staff White Paper does a commendable job in using the HHI index to assess the competitive aspects of the proposed mergers.[20] The HHI index is named after O.C. Herfindahl and A. O. Hirschman and is a recognized index developed in 1992 by the Antitrust Division of the Federal Justice Department and the Federal Trade Commission. It is recognized in both governmental and academic circles as an important device to examine the potential outcomes of proposed mergers.[21] Section V. of Staff's White Paper entitled "Market Power" makes extensive use of industry

[19] Ibid., p. 15.

[20] Staff has developed an alternative index to measure competition in Case 05-C-0616-Proceeding on Motion of the Commission to Examine Issues Related to the Transition to Intermodal Competition in the Provision of Telecommunication Services, Order Initiating Proceeding and Inviting Comments, Issued and Effective, June 29, 2005, pp. 8-9.

[21] See for instance "Economics of Regulation and Antitrust, 3rd edition by W. Kip Viscusi, John M. Vernon, and Joseph E. Harrinton, Jr., The MIT Press, at pp. 147-150.

concentration ratios and the HHI index to show potential negative issues associated with the merger.[22]

Staff uses concentration ratios and the related HHI Index for several sectors of the market including:

- Mass Market Concentration-Retail
- Enterprise Market-Retail
- Transport-Wholesale
- Special Access and High Capacity Loops (Retail and Wholesale).

The concentration ratios and HHI Indices show in most cases that the state of competition would be worse off if the merger occurs. Staff then proposes a series of administrative remedies in an attempt to correct for the loss of competitive advantage that occurs from the proposed merger. A series of seven remedy guidelines are considered at page 17 of the White Paper.[23]

The Department of Justice merger guidelines for using the HHI indicates that a HHI of 1,000 or less shows a market that is not concentrated. An HHI score between 1,000 to 1,800 shows moderate concentration. At that level there is concern if the proposed merger increases the HHI by 100 points or more. If the HHI is greater than 1,800 the market is considered highly concentrated and changes of 50 to 100 points or more lead to concern about market concentration.

Staff shows a number of problematic HHI results in the White Paper. Table 2 shows the HHI for "Wireline Voice Market HHI Res. and Small Business Market" increasing from 3,912 to 4,815 or by 903 points. In the "Data Service above 200kbs HHI Res. and Small Business Market" the HHI increases from 2,799 to 2,808 or by

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[22] See Staff White Paper at pages 12-46.

[23] The guidelines are taken from an October 2004 U.S. Department of Justice Antitrust Division's document entitled "Antitrust Division Policy Guide to Merger Remedies."

only 10 points. This highly concentrated market is essentially left unchanged by the proposed merger. Other highly concentrated markets before and after the proposed merger are illustrated in Tables 2-4 and in Tables 6-7.

Proposed Mass Market-Remedies

Given the apparent problems illustrated by the HHI index, a number of remedies are offered to correct for the market concentration problems in the White Paper. For instance, under "Mass Market Remedies" on page 26 of the Staff White Paper three potential remedies are offered including:

1. Would Verizon offering of unrestricted "naked DSL" stimulate inter-modal competition?

2. We seek comment on whether there are any impediments which impair a customer's ability to switch between wireline, DSL and cable modem based telephone service providers? If so, how are they best overcome?

3. Would freezing MCI's rates, terms and conditions for MCI mass-market customers for 12 months from the date of the merger insulate MCI customers from the short-term negative effects of the merger?[24]

Proposed remedy Number 1, the unrestricted 'naked DSL" option essentially asks Verizon/MCI affiliated entities to compete among themselves instead of having separate corporations compete. This leads us to an enhanced system of more regulation instead of having the market provide customer choice, innovation, and competitive rates.

If the Commission adopts a mechanism such as a naked DSL line for Verizon/MCI, it would have to monitor the market closely to ensure that the service is being actively promoted. Verizon/MCI would be in a position of promoting DSL so a customer could choose services like Voice over Internet Protocol (VoIP) from another

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[24] See Staff White Paper, p. 26.

company. It seems unlikely that if the merger were approved the Commission could somehow reverse its decision on the merger if the process of using a naked DSL service to promote competition failed.

The complex issues associated with Remedy Number 2 could better be solved in the Comp III proceeding where a careful and through consideration of the issues will occur.[25] Since a decision is not expected in that case until December 2005, it is highly problematic to try to solve the issue prematurely in this case. Some of the questions to be solved in the Comp III proceeding are related to Remedy Number 2 being explored here. For example, if a wireline customer switches to DSL or cable modem service they will most likely lose some consumer protections. That very question is being addressed in Case 05-C-0616.[26]

Remedy Number 3, a short term rate freeze of 12 months for MCI customers is also problematic since the merged company could simply wait out the rate freeze period and then change its policies to increase its market share at the expense of consumers.

Remedy Number 1 and Remedy Number 3 discussed above lead to a sort of micro management of the competitive situation. If we reexamine the HHI analysis in Table 6 (for Enterprise Services Business) we can see how the continuation of market forces could lead to a better result. If the Commission kept promoting competition, as set forth in its mission statement and companies such as AT&T, MCI , and Sprint increased their market share by reducing Verizon's advantage, the HHI would actually

[25] Case 05-C-0616-Proceeding on Motion of the Commission to Examine Issues Related to the Transition to Intermodal Competition in the Provision of Telecommunication Services, Order Initiating Proceeding and Inviting Comments, Issued and Effective, June 29, 2005, Appendix A Questions.

[26] Case 05-C-0616-Proceeding on Motion of the Commission to Examine Issues Related to the Transition to Intermodal Competition in the Provision of Telecommunication Services, Order Initiating Proceeding and Inviting Comments, Issued and Effective, June 29, 2005, Appendix A, "Consumer Protections Question Numbers 2 and 3.

fall. If the three companies increased their market share at the expense of Verizon by only 10 percent each over the next ten years, the HHI would fall from the present level of 2,924 to about 2,713. If other firms increased their market share there would be more competition and the HHI would fall.

The public interest would be better served by having more firms engaged in the process than having more regulation with more rules and regulations involved. A complex set of metrics would have to be established to measure progress against remedy Number 1.

Section 2: The petitioners in the Verizon/MCI merger have failed to provide adequate cost and business/financial risk information to allow the Commission or the parties to the proceeding to address the cost savings, synergies, and rate and risk impacts of the proposed merger.

The Staff White Paper makes the following statement at page 9 concerning the rationale for the proposed merger:

> "…Petitioners estimate the merger will generate significant revenues and cost savings for both entities."[27]

Page 59 of the Staff White Paper makes the following observation concerning the value of synergies in the proposed Verizon/MCI merger:

> "One of the main reasons for mergers and acquisitions is that they produce cost savings through economies of scale and scope as well as opportunities for revenue enhancements."[28]

The discussion on synergies and cost savings continues on pages 60-61 of the Staff White Paper where statements attributed to Verizon indicate that pre-tax operating savings and revenue enhancements following the closing of the merger will reach approximately $500 million in year one, $800 million in year two, and will increase to

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[27] See Staff White Paper, p.9.

$1.1 billion in year three and beyond. The present value of these benefits is $7 billion according to the Staff White Paper.

The Staff White Paper at pages 61-62 indicates that there was less than full cooperation by Verizon in presenting evidence on the projected cost savings even making the astounding statement that the cost spreadsheets for the merger do not agree with other key date for the merger proposal. Staff found that estimates were "inconsistently determined" and included improper allocation of operating expenses and capital items. Further Staff admitted that there was no breakdown by subsidiary company and or jurisdiction. This led staff to include in its White Paper the following extremely troubling statement:

> "Staff cannot determine with any precision the amount of synergies applicable to Verizon's New York interstate operations." [29]

The Staff White Paper at page 68 discusses other problematic aspects of the merger including the fact that " MCI did not maintain effective internal control over financial reporting as of December 31, 2004." Staff also discussed the stark fact that the financial statements of MCI may contain material misstatements. Staff tried to review Verizon's oversight of the potential MCI accounting problems and the Staff White Paper at page 68 soberly concludes that:

> "… all Verizon provided were the above unsupported statements."

From a public interest perspective the Commission is being asked to approve a merger with unknown synergy effects that could be in the billions of dollar range. The purchase price for MCI is $8.6 billion, which is about twice the book value of MCI at March 31, 2005 according to the Staff White Paper at page 59. The purchase price may

[28] See Staff White Paper, p. 59.

be inflated due to the bidding process that occurred for MCI earlier in 2005. The unknown synergy cost effects and the problem with the valuation of MCI's financial statements is due in part to poor cost and accounting information provided by the petitioners.

The Staff White Paper then concludes that "based on our limited review," there is no need to institute a rate proceeding to require Verizon to pass on synergy savings to customers. (Staff White Paper page 63). The rate issues are then deferred to the Comp III proceeding. This policy seems due in part to the position addressed in the Staff White Paper that a number of earnings deficiencies for Verizon for 2002 (-11.0%), 2003 (-40.3%) and for 2004 (-36.2%) have occurred and that they will most likely reoccur.

Staff can recommend that a Comp III proceeding be held, but the Commission can not decide the merits of the merger until the public interest aspects of Section 100 of the Public Service Law are examined in detail in this proceeding. The petitioners have a burden of proof requirement to show that the proposed transaction is in the public interest. After reviewing thousands of pages of information it is clear that Staff is unaware of a reasonable estimate of the New York State portion of the synergy savings and much of that knowledge gap is due to the poor cost information maintained by Verizon. This deficiency adds to the other significant public interest deficiency of the merger--the potential loss of competition in the market as outlined in Section 1 above-- provides a basis to reject the Verizon/MCI merger in its entity.

In addition to the problem with accounting for a fair level of synergy savings, the Staff White Paper points out at pages 65-66 that there is substantial input from important bond rating agencies such as Moody's Investors Service and Standard and Poors that due to the enhanced business risk from the merger, the securities of Verizon could be downgraded. Staff illustrates at page 66 of the White Paper that one of the

[29] See Staff White Paper, p. 62.

alleged public interest benefits of the merger-- the proposed synergy saving—could actually lead to more risk if the synergy savings do not materialize. The Commission needs to require a full audit of the synergy savings before it approves the Verizon/MCI merger proposal. It must also make a business and financial risk assessment of the proposed merger if it decides to approve the merger.

Based on this information the Commission should decide the following as related to the three financial issues discussed at page 69 of the Staff White Paper.

1. If the merger is considered, there is a basis to initiate a rate-type proceeding in this case before any decision on the merger is made.

2. Due to the concerns of the financial institutions discussed in the Staff White Paper, a full business and financial risk assessment must be made before the Commission makes a decision regarding the merger.

3. There is little or no evidence in the Staff White Paper that the acquisition appears to be a reasonable competitive response and strategy to growing intermodal competition. In almost all instances the proposed merger leads to less competition according to the HHI indices presented by Staff. Moreover, the petitioners have done an extremely poor job in presenting and justifying any synergy savings, and most of the information in the Business/Financial Risk section of the Staff White Paper shows the potential for increased risk.

Based on the information the Commission should decide the following as related to the three financial remedies discussed at page 69 of the Staff White Paper.

1. Verizon’s New York utility customers should be insulated from all costs and risk related effects from the proposed merger.

2. None of the potential additional equity from the accounting for the merger should be considered in computing Verizon’s New York interstate ROE.

3. The merger can not be approved unless the Commission actually verifies that Verizon’s New York interstate operations will not be impacted as a result of any MCI accounting or other improprieties. There are numerous deficiencies cited by Staff in the financial section of the White Paper. These problems support the recommendation that the decision on the merger be deferred until the issues are properly analyzed in this case in a utility rate-type analysis.

Section 3: The Staff White Paper provided adequate assurances to the public concerning the SBC/AT&T merger and should be adopted in total.

The Staff White paper discusses the proposed SBC/AT&T merger at pages 69-77. Due to the low market share of SBC in New York State in most if not all market areas, the merger does not appear to have a significant anti competitive effect. While there is some evidence that the proposed merger may increase financial risk (Staff White Paper, pp. 75-76) according to Moody's, Staff's conclusion that no additional remedies are needed appears to have adequate support.

Section 4: Summary and Conclusions

The White Paper shows that the proposed Verizon/MCI merger has negative effects on important competitive markers. Also, the significant unknowns concerning synergy cost effects, the potential accounting problems with MCI's accounting statements, and the potential for greater business and financial risk than is present now, support the argument that the Verizon/MCI petition should be rejected unless all the remedies discussed above are accepted. A complete and carefully constructed rate case and accounting valuation analysis must occur in this case before the Commission decides the potential merits of the merger. This rate proceeding should determine the probable outcome of the proposed merger on competitive markets in New York State. Furthermore, under Section 100 of the Public Service Law, the Commission must make an affirmative ruling that the merger is in the public interest. The Commission can not, therefore, take a "time out" today and make a decision on the merger now while deferring the resolution of the critical public interest issues to another proceeding such as Comp III.

The SBC/AT&T merger can be approved now given the review that Staff conducted in the White Paper. Staff found no significant negative aspects of the merger in terms of the level of competition in New York State, rate impacts, and business and financial risk.

Sincerely yours,

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Note: *Original and five copies submitted to Secretary Brilling, and electronic service provided to the Active Parties List in Cases 05-C-0237 and 05-C-0242.*