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May 11, 2006

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PUBLIC SERVICE COMMISSION

Ms. Beth A. O'Donnell
Public Service Commission
211 Sower Blvd.
P. O. Box 615
Frankfort, KY 40602-0615

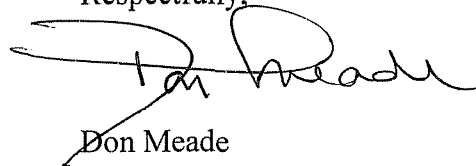
Re: Case No. 2005-00534 – Confidential Filing
Kentucky Alltel, Inc. and Alltel Kentucky, Inc.'s Intent to Transfer Assets to Valor Communications Group, Inc.

Dear Ms. O'Donnell:

The Brief of CWA/IBEW is enclosed. It is being filed under seal in the attached sealed envelope. This notice is sent pursuant to the parties' confidentiality and protective order.

A redacted version is being filed into the Commission's public record and is being furnished to parties not signatory to the protective order. Both a sealed and electronic copy of the confidential brief are being provided to parties signatory to the protective order.

Respectfully,



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BEFORE THE
COMMONWEALTH OF KENTUCKY
PUBLIC SERVICE COMMISSION

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COMMISSION

In the Matter of Application for Approval :
Of the Transfer of Control of Alltel :
Kentucky, Inc. and Kentucky Alltel, Inc. :
:
: Case No. 2005-00534
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:
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:

MAIN BRIEF
OF
COMMUNICATIONS WORKERS OF AMERICA
AND
INTERNATIONAL BROTHERHOOD OF ELECTRICAL WORKERS

*****PUBLIC VERSION*****

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Dated: May 12, 2006

Table of Contents

I. Introduction and Summary of Argument 1

II. Argument 3

A. Legal Standards 3

B. SpinCo and Windstream Will Not Be Financially Fit to Own and Operate a Public Utility in Kentucky 4

1. Introduction 4

2. Legal standards for determining financial fitness 5

3. Windstream will not be financially fit to own and operate a public utility in Kentucky 7

a. Alltel's Board of Directors chose to burden SpinCo with an extraordinary level of debt 7

b. The merger of SpinCo and Valor does not improve the financial condition of SpinCo 9

c. Independent financial experts are finding serious problems with Windstream's financial condition 10

4. The Kentucky ILECs will suffer an immediate, adverse impact from the creation of Windstream 18

5. Conclusion 20

C. The Commission Should Reject the Application 21

D. The Commission Can Impose Conditions on Alltel KY and KY Alltel that Would Protect Alltel KY and KY Alltel from Some of the Effects of Windstream's Inadequate Financing, But Such Conditions Constitute an Inferior Remedy to the Rejection of the Application 21

III. Proposed Conclusions, Findings, and Ordering Paragraphs 24

A. Proposed Conclusions of Law 24

B. Proposed Findings of Fact 24

C. Proposed Ordering Paragraphs 26

IV. Conclusion 28

Appendix : Alternate Proposed Ordering Paragraphs

Table of Citations

PSC v. Mt. Vernon Telephone Co., Ky. 300 SW2d 796 (1956)......5

I. Introduction and Summary of Argument

The Communications Workers of America (CWA) and the International Brotherhood of Electrical Workers (BIEW) files this Main Brief with the Commonwealth of Kentucky Public Service Commission (Ky. PSC or Commission) to set forth CWA and IBEW's position concerning the proposed spin-off by Alltel Corporation (Alltel) of Alltel's local telephone business and associated operations, and the nearly simultaneous merger of that business with and into Valor Communications Group, Inc. (Valor). Specifically, Alltel proposes to create a new corporation, currently known as SpinCo, and to transfer to SpinCo the common stock and other assets of Alltel's local telephone companies, including Alltel Kentucky, Inc. and Kentucky Alltel, Inc. (AKI, KAI, or the Kentucky ILECs), public utilities operating in Kentucky. Immediately after the creation of SpinCo, SpinCo will be merged with Valor, creating a new company to be known as Windstream Communications (Windstream).[1] In other words, the proposed transaction would result in a new entity, Windstream, owning all of the common stock of the Kentucky ILECs and having operational and financial control over the Kentucky ILECs. Approximately 85% of Windstream will consist of SpinCo's assets; the remaining 15% will consist of Valor's existing assets.[2]

In order for the Commission to approve the transaction, the Commission must find that the transaction is in the public interest and that the owner of a utility has the financial capability to provide service. Further, the Applicants have the burden of proving the transaction is consistent with the public interest. (KRS 278.020)

---

[1] Alltel announced the name for Windstream on April 10, 2006. In the record of the case, this new company is usually referred to as NewCo, the Merged Wireline Business, or New Holding Company.

[2] Valor's existing assets include local telephone operations in several states, none of which are in Kentucky.

CWA and IBEW, as the authorized representatives of certain employees of AKI and KAI filed Motions to Intervene in this case because of serious concerns with the financial structure of Windstream. These concerns are highlighted by the fact that Windstream will be leveraged to an extraordinary extent. Indeed, Alltel proposes to create Windstream with a level of long-term debt that will exceed the book value of Windstream's assets. That is, Alltel proposes to create Windstream with debts that exceed the value of Windstream's physical assets. The financial structure of Windstream is so risky that Windstream will not be financially capable to own and operate a public utility in Kentucky.

As a consequence, CWA and IBEW respectfully submit that the best way for the Commission to protect the Kentucky ILECs, as well as the Kentucky ILECs' customers and employees, is to deny the application. This denial should be without prejudice to the right of the Joint Applicants to file a new application that contains an appropriate capital structure for SpinCo and Windstream.

Alternatively, if the Commission believes that it is possible to impose conditions on the Kentucky ILECs to insulate the Kentucky ILECs from the effects of Windstream's financial structure, then the Commission should adopt stringent financial conditions on the Kentucky ILECs that do not have a termination date.

II. Argument

A. Legal Standards[3]

The common stock and assets of AKI and KAI cannot be transferred to SpinCo or Windstream unless the Commission first issues a certificate of public convenience and necessity. This transaction involves the transfer of the title, possession, and use of KAI and AKI from Alltel to SpinCo and then from SpinCo to Windstream.

The statutory provisions of KRS 278.020(5) provide that no person may acquire or transfer control or ownership of a utility without prior approval by the Commission. The Commission shall approve the transfer if it determines that the acquirer has the financial, technical, and managerial abilities to provide reasonable service. The Commission must also determine that the acquisition is made in accordance with the law, for a proper purpose, and is consistent with the public interest. KRS 278.020(6) allows the Commission to grant any application in whole or in part upon terms and conditions it deems necessary or appropriate.

CWA/IBEW challenge the merger as not consistent with the public interest. Kentucky customers will be put at risk by service from a debt riddled company that does not possess the requisite financial capacity to reliably meet future consumer needs. In the alternative, CWA/IBEW urge the imposition of protective conditions under the Commission's authority pursuant to KRS 278.020(6).

[3] A discussion of the legal standards related to the determination of financial fitness is contained in Section II.B.

B. SpinCo and Windstream Will Not Possess the Requisite Financial Capability to Own and Operate a Public Utility in Kentucky

1. Introduction

The concept of financial capability – particularly for the holding companies of fixed utilities – has taken on increased importance after the events of the last few years. The utility industries in general, and the telecommunications industry in particular, have seen a level of holding company abuses, bankruptcies, and imprudent financial structures that is unprecedented since the Great Depression. Enron, Global Crossing, and MCI-WorldCom are just a few of the names that represent the types of financial disasters that can occur when utilities and their holding companies are not held to firm standards to ensure their financial fitness.

While it may be difficult for a state utility commission to exercise control over an existing multi-state utility holding company, there is no question that a commission can prevent the initial creation of a utility holding company that is not adequately capitalized. Unfortunately, that is precisely what the Commission must do in this case. As CWA and IBEW explain in detail below, Alltel is proposing to create SpinCo with an extraordinary level of debt that would seriously jeopardize the financial viability of SpinCo and then Windstream, as well as their local telecommunications utilities including the Kentucky ILECs.

At the outset, it is important to understand that the proposed capital structure and financing plan for SpinCo and Windstream is solely the function of how Alltel decided to divide its assets and liabilities between the two companies. There is nothing about the spin-off itself that requires SpinCo to change its capital structure. Mr. Gardner, the President and Chief Executive Officer of Windstream, testified that Alltel's Board of Directors "had a lot of flexibility in terms of how much leverage to put on this business." Tr. 134-135. In fact, Alltel's Board of Directors was presented with a number of scenarios for capitalizing the new company

CWA-49 (Discussion Materials Prepared for: Cardinal Regarding Potential Wireline Spin-Off Alternatives, dated Sept. 1, 2005).

As CWA and IBEW will discuss below, the capitalization plan chosen for Windstream results in a company that is leveraged to an extraordinary extent and that will not have the financial capability to own and operate public utilities in Kentucky.

2. *Legal standards for determining financial capability*

The Commission may look for guidance to PSC v. Mt. Vernon Telephone Co., Ky. 300 SW2d 796 (1956). Although the Mt. Vernon case arises under a much simpler transaction, in a technologically less sophisticated time, its principles continue to ring true. Mt. Vernon had applied to expand telephone service and sought Commission approval. Through various hearings the Company advanced financing plans for the service extension. None of these plans were backed by definite loan commitments. A number of representations were made to the Commission regarding the financial viability of the Company to undertake the expansion. Commenting upon the record before the Commission, the Court observed:

> It is true that the President of the Company made the bare statement, several times, that the Company was financially able to make the extensions, and the attorneys for the Company on this appeal stoutly maintain that this "uncontradicted" and "positive" evidence of financial ability. However, the facts belied the words, and we are not impressed by the argument that the Commission was required to accept the words in the face of a history of four years of illusory financing proposals." (p. 798)

Although loan commitments have been made in the present case, the testimony of Company witnesses paint optimistic projections that are belied by the hard data and financial analysis contained in the record.

The present Alltel proposal stands in stark contrast to the fiscal responsibility upon which Alltel's acquisition of Verizon was presented to the Commission in Case No. 2001-00399. The

Commission made the following observations about the positive financial position involved in the acquisition and transfer of control:

> One of the primary reasons that Alltel will have the financial ability to provide reasonable service is that it is acquiring a financially sound ongoing business without issuing debt. Additionally, Alltel's financial resources will not be affected by the payment of the purchase price, as Alltel Corporation will provide both the premium and the purchase price. Alltel will not be responsible for any debt issued to acquire the assets and Alltel Corporation will not include the premium or related amortization in Alltel's balance sheet or income statement. (Order, p. 4)

Alltel's pending transaction cannot meet the standards of financial responsibility that were required in the Verizon case. The central question in this case is whether the owner of a fixed utility is financially capable when its debts greatly exceed the value of its physical assets.

It also is instructive to note that the Alaska Regulatory Commission, in similar cases, has denied certificates to competitive, inter-exchange resellers with negative equity because they were not financially fit. *Business Telecom Inc.*, 1998 Alas. PUC LEXIS 238, and *Transcommunications Inc.*, 1997 Alas. PUC LEXIS 98.

From these cases, it is difficult to develop a definitive legal standard or rule. It is reasonable to conclude, however, that the Commission has found the existence of highly leveraged utilities to be troublesome and to raise serious questions about the financial capability of the owner of a public utility. At least one other state commission also has found the existence of negative shareholders' equity to be sufficient grounds to deny a certificate because the applicant lacked financial fitness.

3. *Windstream will not be financially capable to own and operate a public utility in Kentucky*

As CWA and IBEW explained above, the owner of a public utility in Kentucky must be financially capable to own and operate the utility. On this and other measures, Windstream fails the financial capability test and should not be permitted to own and operate the Kentucky ILECs.

a. Alltel's Board of Directors chose to burden SpinCo with an extraordinary level of debt

As of December 31, 2005, the existing capital structure for Alltel's local wireline operations (that would become SpinCo) contains \$238.7 million in debt and \$2,035.9 million of shareholders equity. Gardner Test. Exh. 1, unnumbered p. 1; Tr. 92-95.

Alltel considered a number of scenarios for how to separate SpinCo from Alltel. Tr. 134-135, CWA-49 (Discussion Materials Prepared for: Cardinal Regarding Potential Wireline Spin-Off Alternatives, dated Sept. 1, 2005). For example, the two companies could be separated as they exist. Alternatively, Alltel could have decided that it wanted to recover the amount it invested in SpinCo over the years. This amount appears on SpinCo's balance sheet as the "parent company investment" (similar to inter-company debt) of \$1,504.1 million. Gardner Test. Exh. 1, unnumbered p. 1.

But neither of these options was enough for Alltel. It wanted to go further and obtain a significant advantage from the spin-off. Alltel's Board decided that it wanted to receive a cash payment from SpinCo at the absolute maximum amount it could receive without paying federal income taxes, which is \$2.4 billion. Tr. 99 – 100. This amount is <u>in addition to</u> the \$1.5 billion in "parent company investment" that is being repaid by SpinCo. Gardner Test. Exh. 1, unnumbered p. 5, ¶ b.

That is, as a result of the transaction chosen by Alltel's Board, Alltel will receive a cash payment of $2.4 billion from SpinCo, in addition to the retirement (by SpinCo) of $1.5 billion in Alltel debt.

This raises two questions: (1) Why would Alltel's Board do this? and (2) Where does SpinCo come up with $3.9 billion in cash?

The first question, unfortunately, is rather easy to answer. Alltel's Board of Directors does not owe any obligation to the future stockholders of SpinCo. The extent of the Board's duty in a spin-off transaction is to ensure that the new company (SpinCo) will not become insolvent as a result of the separation payment. That is why the analysis from Duff & Phelps is termed a "Solvency Analysis." AG 2-95A (Alltel Wireline, Solvency Analysis Presentation to the Board of Directors dated May 4, 2006 hereinafter referred to as AG 2-95A). As long as the transaction can meet the four tests of solvency (AG 2-95A p. 8), then it is lawful for Alltel's Board to approve the transaction.

The solvency tests do not require Alltel's Board to create a strong company; merely that it create one that will not have "an unreasonably small amount of capital" and that will be able to "pay its liabilities ... as they mature." (*Id.*)

The second question – how does SpinCo get the money – is also fairly simple to answer. As might be expected, SpinCo does not have $3.9 billion in cash sitting around. In fact, at December 31, 2005, SpinCo had cash and short-term investments of just $11.9 million. Gardner Test. Exh. 1, unnumbered p. 1. So where does a company with less than $12 million in cash come up with $3.9 billion to pay for the privilege of separating from its parent company?

The answer, of course, is that it has to borrow it. It is that borrowing that is the source of CWA and IBEW's concerns in this proceeding.

As discussed above, as of December 31, 2005, the existing capital structure for SpinCo contains $238.7 million in debt, $1,504.1 million of inter-company investment, and $2,035.9 million of shareholders equity. Gardner Test. Exh. 1, unnumbered p. 1; Tr. 92 - 95. So SpinCo's total capitalization is about $3.7 billion, of which about $2 billion is equity and $1.7 billion is debt. By way of comparison, SpinCo's net utility plant totals $2,963.6 million, so most of the capital is supported by physical assets.

Under the plan adopted by Alltel's Board, SpinCo's resulting capital structure would contain $5,099.0 million in debt and negative $258.1 million of common equity. Gardner Test. Exh. 1, unnumbered p. 1 (common equity is total of "Additional paid-in capital" and "Retained earnings (deficit)"). This $4.8 billion worth of capital would be supported by only $3,046.5 million worth of net utility plant.[4] Such a radical shift in the capital structure of SpinCo – wiping out more than $2 billion of common equity and borrowing in excess of $4.7 billion – is not required in order for the spin-off to occur; it is simply a corporate decision that was made by Alltel for the benefit of Alltel.[5]

b. The merger of SpinCo and Valor does not improve the financial condition of SpinCo

The subsequent merger of SpinCo into Valor to create Windstream does not significantly change the financial condition of SpinCo. Valor's current capital structure is also highly leveraged with $1,180.6 million of long-term debt, $571.7 million of common equity, supported by just $717.5 million of physical assets. Gardner Test. Exh. 1, unnumbered p. 1. Valor's existing bond rating is BB-, which is well below investment grade. CWA-47 ("Valor

[4] The increase in net plant reflects the transfer of $82.9 million worth of plant from Alltel to SpinCo. Gardner Test. Exh. 1, unnumbered p. 5, ¶ a.
[5] In addition to the $3.9 billion that will be borrowed to pay Alltel, and SpinCo's existing $238 million in debt, SpinCo will borrow an additional $767 million to refinance the debt of Valor. Tr. 102-103. This brings SpinCo's total debt to approximately $5 billion. Tr. 102 .

Communications Group Inc. Ratings Placed on Watch Positive After Merger Announcement"). After the merger, it is anticipated that Windstream's bond rating also will be below investment grade. Tr. 188. Similarly, Windstream is projected to have $5,517.0 million of long-term debt[6] and $552.7 million of common equity, supported by just $3,764.0 million of physical assets. Gardner Test. Exh. 1, unnumbered p. 1.

Incredibly, while Windstream will begin operations saddled with $5.5 billion in debt (most of which is new debt), it will have very little cash. The projected opening balance for cash and short-term investments is just $58.5 million – which is less than Valor had on a stand-alone basis at December 31, 2005. Gardner Test. Exh. 1, unnumbered p. 1 (showing that Valor's cash at year-end 2005 was $64.2 million). That is, the entire proceeds of the bank debt (plus some of SpinCo's and Valor's cash) will be given to Alltel, but the loan will be repaid by Windstream.

While Mr. Gardner acknowledges that Windstream will not end up with any cash when it borrows $5 billion, he seems to think that this is no problem because Windstream can simply borrow more money from the revolving credit facility (Tr. 101). In fact, though, despite the unbridled optimism of Mr. Gardner, there are serious problems with Windstream's financial condition.

c. Independent financial experts are finding serious problems with Windstream's financial condition

Fitch Ratings. When Alltel announced this transaction, on December 9, 2005, Fitch Ratings immediately downgraded the debt ratings on Alltel's wireline debt. CWA St., Sch. DG-4. The downgrading was a severe drop of four ratings notches (from A to BBB-) and indicated that the debt was being placed on Rating Watch Negative, meaning that "a further downward

[6] Windstream's debt consists of the $5 billion in SpinCo debt discussed above, plus a $500 million revolving credit agreement. Gardner Test. Exh. 1, unnumbered pp. 5-6, ¶ f.

rating action could occur, depending on the ultimate capital structure of the new wireline company, and the position of the operating company bonds within the new capital structure." *Id.*, p. 1. Fitch explained its concerns about the transaction, as follows:

> Fitch expects the leverage of the new wireline operations to be approximately 3.2 times with a dividend payout of 70%. However, these levels do not likely afford the company with sufficient financial flexibility to maintain an investment-grade rating given Fitch's expectation for continued EBITDA erosion. ... In addition, Fitch remains concerned over the lack of growth opportunities and service diversity as a standalone wireline operator.

Id., p. 1.

Duff & Phelps. Alltel commissioned Duff & Phelps to prepare a 10-year analysis of Windstream's financial condition, beginning with management's projections for the first five years. Duff & Phelps begins by making an incredibly optimistic projection: that interest rates **{Begin Confidential}** XXXXX **{End Confidential}** for ten years, even as Windstream's financial condition deteriorates. Conf. Tr. 35.

Even with that projection, Duff & Phelps cannot even come close to supporting the optimistic outlook put forth by Mr. Gardner. One of the more obvious indications of the difference between the Windstream/Alltel outlook and an independent look is the projected common stock price for Windstream. In December 2005, Alltel's Board was given a projection that the likely value of Windstream's common stock at the time of the spin-off and merger would be **{Begin Confidential}** XXXXX **{End Confidential}** per share. CWA-60 (Presentation to the Board of Directors Separation of Alltel Wireline, dated Dec. 2005, page 13). In stark contrast, Duff & Phelps is projecting that the likely value of Windstream at the time of its creation would be only **{Begin Confidential}** XXXXX **{End Confidential}** per share – some 40% less than the Company's projection. AG 2-95 B, p. V-A-7 (Duff & Phelps, Alltel Wireline Supporting Analysis Detail dated May 4, 2006, hereinafter referred as AG 2-95 B).

Further, this is the case even though Duff & Phelps appears to be using information for 2005 that does not reflect Windstream's most current (and less optimistic) information for that year. Thus, for example, the Duff & Phelps analysis has Windstream beginning with $106 million in cash (Conf. Tr. 58 - 59) even though Mr. Gardner shows that Windstream will begin with only $58.5 million in cash (Gardner Test. Exh. 1, unnumbered p. 1; Conf. Tr. 58-9). Similarly, Duff & Phelps shows the initial amount of long-term debt to be $5,380 million (AG 2-95B, p. V-A-5), compared to Mr. Gardner's figure of $5,517 million (Gardner Test. Exh. 1, unnumbered p. 1). Thus, Duff & Phelps' analysis starts from a considerably more optimistic point than would appear warranted: an additional $47 million in cash and $137 million less in debt.

Even with this built-in advantage, though, Duff & Phelps believes that Alltel greatly over-estimates the initial value of Windstream's common stock.

From there, it only gets worse. Using the Company's projection of declining revenues and earnings and the too-optimistic cash and debt levels (the so-called "base case"), and continuing to assume no change in interest rates, Duff & Phelps concludes that:

{Begin Confidential}

{End Confidential}

Duff & Phelps also conducted a sensitivity analysis to determine what would happen to Windstream under "a reasonable downturn." AG 2-95A, p. 28. Duff & Phelps modeled this as a decline in revenues of **{Begin Confidential}** XXXXX **{End Confidential}** per year instead of the **{Begin Confidential}** XXXXX **{End Confidential}** annual reduction assumed by Windstream's management. Conf. Tr.51-52.

Under this sensitivity case, the condition of Windstream would deteriorate significantly. For example:

{Begin Confidential}

{End Confidential}

Simply, the Duff & Phelps analysis appears to be overly optimistic – both in its starting point and in its forecast of the stresses that would be placed on a business with declining revenues, declining earnings, declining net plant values, falling stock price, and a reduced dividend. Even with its infirmities, though, the Duff & Phelps analysis concludes that the Windstream business will be sorely stressed, particularly if there is an economic downturn.

Banks. The consortium of banks that has committed to lend Windstream more than $5 billion also appears to have concluded that this would be a risky investment. Specifically, the banks are requiring liens and guarantees in their favor on Windstream's assets in the seven states that do not require regulatory approval and on Windstream's unregulated businesses. Tr. 55. The banks also require a pledge of the common stock that Windstream holds in its subsidiaries (including the Kentucky ILECs). Tr. 56.

In addition to these security requirements, the banks also will impose stringent conditions on how Windstream can conduct its business. For example, the banks will be placing an upper limit on how much Windstream can spend on capital improvements. The amount is not known yet – which is troublesome in itself – but as Mr. Schiedemeyer testified, this type of condition is required for the banks to ensure that Windstream has sufficient cash to repay its loans. Conf. Tr. 49 -50.

Similarly, the banks are prohibiting Windstream from entering different lines of business, acquiring any other companies or operating assets, or selling assets, among many others. Revised Commitment Letter, Exh. A, p. A-7 (Negative Covenants), Attachment to Mark R. Overstreet Letter to Dennis Howard, dated April 18, 2006.[7]

While the parties to this case are not privy to the banks' financial analysis, it seems clear from the extraordinary level of security and other restrictions that the banks are attempting to insulate themselves from a substantial level of risk. This type of financing is not "business as usual" for a utility holding company and it provides yet a further indication that there is something wrong with the financial structure that Alltel has chosen for Windstream.

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[7] The Amendment to Commitment Letter dated April 12, 2006 amends the Commitment Letter dated Dec. 8, 2005. The original Commitment Letter is an attachment (Exhibit 7) to the Amended and Restated Application for Approval of Transfer and Authorization to Guarantee Indebtedness that was filed by the Applicants on Jan. 23,

Morgan Stanley. On April 17, 2006, Morgan Stanley Research issued a Research Report in which it analyzed the high-dividend high-leverage capital structure of Windstream and other rural local exchange carriers. (Joint Applicants Hearing Exhibit 1). Addressing investors, Morgan Stanley warned that while these carriers, including Windstream, may offer "near-term opportunities," they also provide "long-term risks," defined as early as three years from now. (*Id.*, p. 1) Specifically, Morgan Stanley believes that Windstream will be forced to cut its dividends after only three to five years "given the declining nature" of its business, making the stock price unattractive. (*Id.*, p. 14) Moreover, the high dividend payout structure will prove unstable if "capital spending levels prove to be unsustainably low or companies experience large swings in operating expenses." (*Id.*, p. 9)Finally, Morgan Stanley worries that if any one of the rural local exchange carriers that have adopted this capital structure stumbles, "all could fall." (*Id.*, p. 13) In sum, Morgan Stanley concludes that within three to five years, Windstream will face the choice of cutting capital expenditures, operating expenses, and/or dividends. If it chooses to maintain a high dividend pay-out to keep the stock price up, Windstream will be forced to cut capital expenditures or operating expenses.

AG witness Brevitz. The Office of the Attorney General (AG) presented the testimony of an independent expert witness, David Brevitz.[8] Mr. Brevitz reviewed the proposed financing plan for Windstream and found it to be seriously deficient, and far weaker than Alltel is today. Mr. Brevitz' conclusions include the following:

> The Commission should not consider the transaction as structured by Alltel Corporation...to be "arms-length" in nature. The New Holding Company has not

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2006. The specific terms and conditions required by the lenders appear in the Summary of Terms and Conditions attached to the commitment letter (labeled Exhibit A to the Commitment Letter).

[8] Mr. Brevitz is a Chartered Financial Analyst and M.B.A. with more than 20 years experience as a telecommunications analyst who has testified as an expert witness before numerous state regulatory commissions. AG St. pp. 1-2.

demonstrated its ability to take independent views and actions in the structure of the spin-off. (AG St., p. 7)

> Alltel has chosen to put an excessive level of debt burden on the new Holding Company which conflict with the new Holding Company's own financial goals. (AG St., p. 6)
>
> It is clear that the equity of the Alltel ILECs that had been built up over time is substantially dissipated (and remains with the parent) and replaced with a debt burden as the wireline business is spun off. (AG St., p.19)
>
> Neither scenario – the management projection or Duff & Phelps "reasonable downside scenario" indicates the announced dividend will be stable. Financial distress would be severe...the company would be severely burdened with debt, and unable to eliminate it. (AG St., pp. 28-29)
>
> The Commission may reasonably expect that capital expenditures will be reduced, operating expenses will be reduced with resultant impacts on service quality, and that rate increases will be sought. (AG St., p. 32).

CWA and IBEW witness Goldman. Debbie Goldman, an economist with CWA, also analyzed the proposed financing plan for Windstream and independently reached conclusions that are remarkably similar to Mr. Kahal's.[9] Ms. Goldman concluded, for example:

> [T]he New Holding Company [Windstream] will be a highly leveraged, financially weak company, with fewer resources to invest in the Kentucky ILECs' networks and to provide quality, reliable service to customers. The financial analysis provided by the Joint Applicants contains <u>overly optimistic financial projections</u>. ... [A] financial analysis based on more realistic projections indicates that the New Holding Company will <u>likely experience severe financial constraints within just a few years after the proposed transaction</u>. (CWA/IBEW St., p. 2 (emphasis added))
>
> The proposed transaction will produce a radical change in the financial condition of the New Holding Company from which the Regulated Entities will obtain capital to invest in their business. (CWA/IBEW St., p. 4)
>
> The projections are highly aggressive. If any of the assumptions prove wrong – if revenues decline more quickly, if the new entity increases the dividend to keep up

[9] Ms. Goldman has degrees in History, Public Policy, and Education from Harvard University, University of Maryland, and Stanford University, respectively. She has been employed as a Research Economist for more than 13 years, focusing on telecommunications policy, financial analysis, and other regulatory issues. She has testified or prepared formal comments in more than 55 proceedings before the Federal Communications Commission, state regulatory commissions, and the U.S. Department of Justice. CWA St. 1, p. 1.

> with inflation or higher interest rates, if the transaction-related cost savings are not realized, or if competitive pressures and service needs require higher capital expenditures – <u>then the New Holding Company will not be able to generate the cash from operations needed for dividends, capital spending, interest and taxes just one year after the transaction.</u> (CWA/IBEW St., p. 10 (emphasis added))

Ms. Goldman conducted a sensitivity analysis that is very similar to the one conducted by Duff & Phelps. Ms. Goldman concluded that under a reasonable downturn scenario (5% decline in earnings, dividend growth of 3% to keep up with inflation, and capital expenditures equal to actual expenditures in 2005), Windstream's cash flow would turn negative in 2007 – just one year after its creation. If those conditions continued in 2008, cash flow in 2008 would be negative $101 million. CWA/IBEW St., p. 11. Ms. Goldman concluded that this analysis raises "the very real question of whether the New Holding Company will be able to refinance the bank debt when it comes due in five and seven years, when interest rates are likely to be higher." CWA/IBEW St., p. 10.

In summary, six independent financial analyses all reach the same conclusions: (1) Windstream will be considerably more risky than Alltel; (2) Windstream's ability to continue to raise capital and refinance its debt when it becomes due is questionable if the business declines more rapidly than Windstream projects, or if economic conditions worsen; (3) even under Windstream's rosy projections, it is unlikely that Windstream will be able to maintain its initial common stock dividend; (4) it is likely that Windstream's stock price will be much lower than Alltel projected, and that stock price will decline steadily even under the best of conditions; and (5) all of these factors will affect Windstream's ability to raise capital and continue to invest in its networks.

4. The Kentucky ILECs will suffer an immediate, adverse impact from the creation of Windstream

There is one other, important impact on the Kentucky ILECs from the creation of Windstream. In 2005, Alltel's wireline business and Valor collectively invested $400.5 million on additions to property, plant, and equipment. Gardner Test. Exh. 1, unnumbered p. 3. Alltel, SpinCo, and Windstream project that they will invest a similar amount in the wireline business, $400 million, in 2006. Tr. 89. But Windstream's investment in new plant will decline to $375 million in 2007 and remain at that reduced level through 2008 and beyond. Tr. 89.

Windstream could not tell us how much of that spending reduction would be felt in Kentucky . Tr. 90. What we do know, however, is that the entire $25 million per year cut in capital spending will be assigned to current Alltel properties; none of it will be felt by current Valor operations. Conf. Tr. 34.

Moreover, even the reduced spending level of $375 million per year may not be sustainable. Ms. Goldman's analysis shows that under a reasonable downturn scenario, maintaining that level of capital investment would result in Windstream having negative cash flow as early as 2007. CWA St. 1, p. 11. The Duff & Phelps analyses show that for Windstream to maintain capital spending at $375 million per year would require a reduction in the common stock dividend – or some other major reduction in cash outlays – no later than {**Begin confidential**} XXXXX {**End confidential**} (in the base case), and perhaps as early as {**Begin confidential**} XXXXX {**End confidential**} (in the sensitivity case). Conf. Tr. 43, AG 2-95B, p. V-B-3. As Mr. Schiedemeyer from Duff & Phelps testified, his analysis is really a modeling exercise. The results of the analysis would be identical if, instead of reducing the common stock dividend, Windstream chose to reduce capital spending instead. Tr. 43 - 44. Thus, while his analysis shows a reduction in cash outlays of {**Begin confidential**} XXXXX {**End**

confidential} from reducing the dividend, it is just as likely that management could choose to reduce capital expenditures by the same amount to achieve the desired improvement in cash flow. AG2-95B, p. V-A-7.

In other words, we know that capital spending will be reduced by about 6% beginning in 2007. We know that the entire spending reduction will be assigned to current Alltel properties. We also know that even that reduced level of capital spending may not be sustainable, given the precarious financial position that Alltel is creating for Windstream. Further, the company cannot say how much of that reduction will be felt in Kentucky. And, finally, Windstream's management does not provide any prospective information to the Commission or the public that would allow the situation to be monitored.

Moreover, Windstream anticipates significant reductions in its customer service operations after the transaction, projected at **{Begin Confidential}** XXXXX **{End Confidential}** annual savings. CWA St., Schedule DG-6. According to Alltel, the largest portion of these so-called synergy savings **{Begin Confidential}** XXXXX **{End Confidential}**. (*Id.*) Clearly, closure of call center operations will have an impact upon the quality of service provided to customers, particularly during the conversion period.[10]

The planned reductions in capital expenditures and customer service operating expenses provide further indication that the proposed transaction is not in the best interests of the Kentucky ILECs or their customers. Maintaining and enhancing the level of capital investment in the Kentucky ILECs networks is absolutely crucial if Alltel is to improve the level and reliability of its service to its Kentucky consumers. But this transaction moves the Kentucky ILECs in the wrong direction – it will reduce available capital at a time when more is needed.

6. *Conclusion*

CWA and IBEW submit that the Commission must find that Windstream will not be financially fit to own and operate the Kentucky ILECs. Alltel is loading too much debt onto SpinCo and Windstream and is creating a company that appears destined to fail. The Applicants' own projections show that Windstream's net income and cash flow will decline significantly each year and Windstream's level of net plant investment will decline significantly. This will jeopardize the Kentucky ILECs ability to continue to invest in their networks and to improve the reliability of service.

Alltel apparently no longer wants to own the local telephone business. While corporations should have considerable latitude in determining how to structure their business, there must be limits on that latitude when a public utility is involved – a public utility that is providing an essential service to the public. One of those limits is that the utility and its holding company must be financially capable; they must be appropriately capitalized; they must not be so weakened financially that they have little hope of surviving if events do not follow the somewhat rosy projections being made.

For reasons that appear to have more to do with Alltel's wireless business than with the viability of Windstream and the Kentucky ILECs, Alltel has chosen to saddle Windstream with an extraordinary level of debt. The Commission should reject this attempt to create an inadequately capitalized utility holding company. The Commission should find that Windstream will not be financially fit to own and operate public utilities in Kentucky.

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[10] The Commission required Alltel to hire and train 240 new customer service workers to avoid conversion difficulties as one among a number of conditions in approving Alltel's acquisition of properties from Verizon in 2002. Goldman St., Schedule DG-5.

C. The Commission Should Reject the Application

The Commission, utilities, and the statutory parties typically approach this type of case with an understanding that it might be necessary for the Commission to impose conditions in order for the transaction to be approved. In this case, however, CWA and IBEW submit that the typical types of conditions will not remedy the harm created by the transaction.

The harm, as discussed above, is that the holding company will not be financially capable. That lack of capability stems from the inappropriate allocation of assets and debts between the existing holding company (Alltel) and the new holding company (Windstream).

CWA and IBEW recognize that it is not the role of the Commission to tell holding companies precisely how they should be capitalized or operated. The Commission certainly can disapprove a transaction, but that is very different from then directing that the transaction be conducted in a particular manner.

CWA and IBEW conclude, therefore, that the best method available to the Commission to ensure the financial fitness of Windstream is to deny the application. That denial should be without prejudice to the right of the Applicants to re-file the application to reflect a new financial structure for Windstream, so long as CWA and IBEW and the other parties are given an adequate amount of time to assess the impacts of any such changes that are filed.

D. The Commission Can Impose Conditions on the Kentucky ILECs that Would Protect the Kentucky ILECs from Some of the Effects of Windstream's Inadequate Financing, But Such Conditions Constitute an Inferior Remedy to the Rejection of the Application

If the Commission is seeking to avoid the outright rejection of the Application, the Commission could consider the imposition of conditions on the Kentucky ILECs. Such conditions would be designed to protect the Kentucky ILECs from the consequences of future financial problems at Windstream. Because such conditions would be placed on the Kentucky

ILECs (and not on Windstream), CWA and IBEW consider such an approach to be an inferior remedy to the rejection of the Application. It may be possible, however, to craft a series of conditions that insulate the Kentucky ILECs from the adverse effects of Alltel's decision to inadequately capitalize Windstream.

Such conditions should be designed to prevent attempts by Windstream to siphon cash or other assets from the Kentucky ILECs. These types of conditions would not fully protect the Kentucky ILECs from all of the adverse consequences of a financial disaster at Windstream, but they would at least provide some level of insulation against effects of Windstream's inadequate capitalization.

In particular, if the Commission desired to use this approach – effectively building a financial "wall" around the Kentucky ILECs, ensuring the reliability and quality of the Kentucky ILECs service, and maintaining the stability of a skilled work force – then CWA and IBEW would propose the following conditions, as discussed in Ms. Goldman's testimony (CWA St., pp. 23-24):

- Windstream shall not be required to pay Alltel for its assets. Any proceeds from bank or public debt shall be retained by the New Holding Company for its investment purposes.

- The Kentucky ILECs shall maintain a capital structure that contains at least 65 percent common equity. The Kentucky ILECs shall be prohibited from paying any dividend to its parent company that would reduce the Kentucky ILECs' equity ratio to less than 65 percent.

- The Kentucky ILECs shall not pay any dividend to its parent company that exceeds more than 75 percent of the Kentucky ILECs' earnings attributable to common equity and the Kentucky ILECs shall not pay any dividend to its parent that exceeds 75 percent of cash flow (defined as operating earnings after cash interest expense and cash taxes).

- If Windstream's credit rating is downgraded below its initial credit rating, the Windstream shall be required to reduce its dividend by 5 percent for each rating point downgrade.

- The Kentucky ILECs shall provide a guaranteed minimum of $80 million capital expenditures each year for the next five years.

- The Commission shall require each District served by the Kentucky ILECs (East, Central, and West) to clear 95 percent of out-of-service reports within 24 hours; provide 95 percent of regular service installations within 5 days; and meet a trouble reporting objective of 2 or less per 100 lines. The Commission shall adopt financial penalties for failure to achieve these objectives in any District in any month.

- The Kentucky ILECs reporting of service performance shall be posted on the Commission website.

- The Kentucky ILECs shall be required to maintain or grow current employment levels and Windstream shall be required to maintain or grow current customer service employment levels at existing call centers for the next five years. The Kentucky ILECs shall be required to maintain employees currently working at API, with no reduction in compensation, and full respect of union status and collective bargaining agreements.

- The division of pension fund assets between Alltel and the New Holding Company shall be proportional to the prospective pension fund liabilities of the two entities.

These types of conditions would help to protect the Kentucky ILECs, their customers, and their employees from the adverse impacts of the proposed financial structure of Windstream. They would require the Kentucky ILECs to retain a reasonable level of its earnings to support and enhance service to its customers in Kentucky. These conditions also would prevent Windstream or any other affiliate from siphoning cash out of the Kentucky ILECs, or otherwise depleting the Kentucky ILECs' assets, to serve the extraordinary debt service requirements being placed on Windstream.

CWA and IBEW would emphasize that these conditions are inferior to an outright rejection of the Application, which would require Alltel to restructure the transaction. But the imposition of such conditions would at least provide some measure of protection for the Kentucky ILECs, their customers, and their employees.

III. Proposed Conclusions, Findings, and Ordering Paragraphs

A. Proposed Conclusions of Law

1. The Commission cannot approve a transfer unless it finds that the acquirer has the financial, technical, and managerial abilities to provide reasonable service, and that the acquisition is consistent with the public interest.

2. The Commission is empowered to impose such conditions upon a transfer of control as it deems necessary or appropriate to protect the public interest.

3. The Commission is granted great latitude in determining the conditions to impose upon a transfer of control.

4. The existence of debt that greatly exceeds the value of the holding company's physical assets is sufficient to permit the Commission to conclude that an applicant is not financially capable to own or operate a public utility in Kentucky.

5. The Kentucky ILECs, as the applicants, bears the burden of proof in this proceeding.

6. The Kentucky ILECs have the burden of proving that Windstream is financially fit to own and operate a public utility in Kentucky.

7. If a utility holding company is not financially capable, the Commission is prohibited from approving the transfer of control.

B. Proposed Findings of Fact

1. The Kentucky ILECs have not met their burden of proving that the proposed transaction, without conditions, will affirmatively promote the service, accommodation, convenience, or the public interest in some substantial way.

2. SpinCo is a holding company that will be created by Alltel to own the Kentucky ILECs and other Alltel local telephone companies.

3. Windstream is a holding company that will be created by the merger of SpinCo and Valor to own and operate the Kentucky ILECs and other Alltel local telephone companies.

4. Alltel has chosen to create SpinCo with an initial capitalization that consists of debt greatly in excess of the value of SpinCo's physical assets.

5. SpinCo's debt would be equal to 167% of the book value of its net utility plant (debt of $5,099.0 million; net property, plant, and equipment of $3,064.5 million).

6. If goodwill were excluded (as would be the case under traditional ratemaking), SpinCo would have shareholder's equity of negative $1,475.9 million (book equity of -$258.1 million less goodwill of $1,218.7 million).

7. Alltel has chosen to create Windstream with an initial capitalization that consists of debt greatly in excess of the value of Windstream's physical assets.

8. Windstream's debt would be equal to 147% of the book value of its net utility plant (debt of $5,517.0 million; net property, plant, and equipment of $3,764.0 million).

9. If goodwill were excluded (as would be the case under traditional ratemaking), Windstream would have shareholder's equity of negative $1,820.9 million (book equity of $552.7 million less goodwill of $2,313.6 million).

10. Windstream projects that its net income will decline during each of the next five years.

11. Windstream will be a holding company with negative shareholders' equity, debt that greatly exceeds the book value of its assets, projected declines in net income over an extended period of time, and other serious financial problems.

12. SpinCo is not financially capable to own a public utility in Kentucky.

13. Windstream is not financially capable to own and operate a public utility in Kentucky.

14. Any conditions that the Commission could impose on the Kentucky ILECs are inadequate to address the fundamental problems with SpinCo's and Windstream's financial structures.

15. The $5 billion in parent-company financing is being used to pay (a) $2.4 billion as a separation dividend to Alltel, which will be an unregulated company primarily providing wireless telecommunications service; (b) a $1.5 billion loan to the same unregulated company to enable Alltel to retire some of its existing debt; and (c) $875 million to enable the parent company to acquire a telecommunications holding company that does not operate in Kentucky.

16. Various subsidiaries of Windstream will provide both regulated and unregulated services.

17. Windstream's unregulated lines of business will include Internet service, directory publishing, telephone information services, television service, and wireless telecommunications service, among others.

C. *Proposed Ordering Paragraphs*[11]

1. The Applicants have not demonstrated that SpinCo or Windstream have the requisite financial capability to own and operate a public utility in Kentucky.
2. The Application filed at Case No. 2005-00534 is DENIED without prejudice to the right of the Applicants to file a new application that modifies the financial structure of

[11] The Proposed Ordering Paragraphs reflect CWA and IBEW's primary position: that the Commission should deny the Application. Proposed Order Paragraphs that reflect CWA and IBEW's alternate position, that the Commission could impose reasonable conditions on the Applicants, are provided in Appendix A to this Brief.

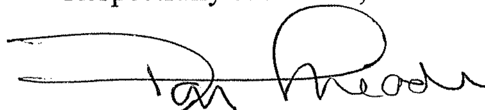
SpinCo and Windstream to reflect a fair allocation between SpinCo and Alltel of assets, cash, long-term debt, and shareholders equity.

IV. Conclusion

In conclusion, CWA and IBEW respectfully request the Commission to find that SpinCo and Windstream are not financially capable. CWA and IBEW also request the Commission to deny the Application, without prejudice to the right of the Applicants to file a new application that modifies the financial structure of SpinCo and Windstream.

After the lessons of Enron, Global Crossing, MCI-WorldCom, and others, the Commission must not sanction the creation of an inadequately capitalized utility holding company.

Respectfully submitted,



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Dated: May 12, 2006

Appendix A

Alternate Proposed Ordering Paragraphs

1. The Applicants have not demonstrated that SpinCo or Windstream will have the requisite financial fitness to own and operate a public utility in Kentucky, or that the assets and service quality of The Kentucky ILECs will be protected, unless the following conditions are imposed:

    a. Windstream shall not be required to pay Alltel for its assets. Any proceeds from bank or public debt shall be retained by Windstream for its investment purposes.

    b. The Kentucky ILECs shall maintain a capital structure that contains at least 65 percent common equity. The Kentucky ILECs shall be prohibited from paying any dividend to its parent company that would reduce The Kentucky ILECs' equity ratio to less than 65 percent.

    c. The Kentucky ILECs shall not pay any dividend to its parent company that exceeds more than 75 percent of the Kentucky ILECs' earnings attributable to common equity, and the Kentucky ILECs shall not pay any dividend to its parent that exceeds 75 percent of cash flow (defined as operating earnings after cash interest expense and cash taxes).

    d. If Windstream's credit rating is downgraded below its initial credit rating, Windstream shall reduce its dividend by 5 percent for each rating point downgrade.

    e. The Kentucky ILECs shall provide a guaranteed minimum of $80 million capital expenditures each year for the next five years.

    f. The Commission shall require each District served by the Kentucky ILECs (East, Central, and West) to clear 95 percent of out-of-service reports within 24 hours; provide 95 percent of regular service installations within 5 days; and meet a trouble reporting objective of 2 or less per 100 lines. The Commission shall adopt financial penalties for failure to achieve these objectives in any District in any month.

    g. The Kentucky ILECs' reporting of service performance shall be posted on the Commission website, or on the Kentucky ILECs's web site with a link from the Commission's web site.

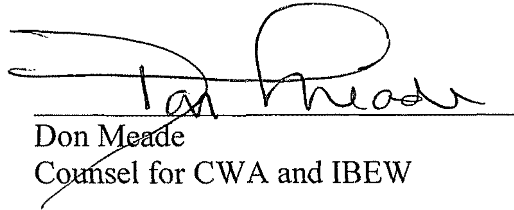
h. The Kentucky ILECs shall maintain or grow current employment levels and Windstream shall maintain or grow current customer service employment levels, for the next five years. The Kentucky ILECs shall maintain employees currently working at the Kentucky ILECs, with no reduction in compensation, and full respect of union status and collective bargaining agreements.

i. The division of pension fund assets between Alltel and the Windstream shall be proportional to the prospective pension fund liabilities of the two entities.

2. The Application filed at Case No. 2005-00534 is DENIED, unless Applicants file a compliance filing with the Secretary of the Commission within fifteen (15) days of the date of this Order that accepts all of the conditions set forth herein.

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a true copy of the foregoing upon the following parties to this proceeding by electronic mail and either first class mail (public parties) or express delivery (Applicants).



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Dated: May 12, 2006

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