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In the Matter of a Commission Inquiry into Frontier Communications' Virtual Separation Analysis

Docket No. P-405,407,5316/CI-21-150

INITIAL COMMENTS OF THE MINNESOTA DEPARTMENT OF COMMERCE

INTRODUCTION

In September, the Minnesota Public Utilities Commission directed interested parties to investigate the meaning and purpose of virtual separation, as used by Frontier Communications in its recent Chapter 11 restructuring plan.[1] As part of this investigation, the Commission also asked parties to consider the potential impact on service quality and the potential impact on future investment in Minnesota.[2] As requested by the Commission, the Minnesota Department of Commerce investigated the meaning and purpose of Frontier's virtual separation methodology and its potential impact on Minnesota customers.[3]

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[1] *In re Comm'n Inquiry into Frontier Commc'ns Virtual Separation Analysis,* Docket No. P-405,407,5316/CI-21-150, ORDER SETTING INQUIRY SCOPE AND SCHEDULE (Sept. 29, 2021) ("Order"); *In re Joint Appl. of Frontier Commc'n Corp. Corporation for Approval of a Transfer of Control Due to a Chapter 11 Plan of Reorganization of Frontier Commc'ns Corp. & Its Subsidiaries*, Docket No. P-405, P-407, P-5316/PA-20-504, ORDER APPROVING TRANSFER OF CONTROL OF MINNESOTA TELECOMMUNICATIONS SUBSIDIARIES (Dec. 7, 2020).
[2] *Id.*
[3] Order at 7–8.

ANALYSIS

I. VIRTUAL SEPARATION

In Frontier's draft bankruptcy reorganization plan, the company proposed to make "commercially reasonable best efforts to analyze and develop a detailed report regarding a virtual separation under the same ownership structure of select state operations . . . ."[4] Frontier subsequently explained that virtual separation was intended to identify, assign and track its indirect costs and financial expense data across its twenty-five state operations, including Minnesota.[5] While direct costs, such as materials or labor used to make a product, can often be more easily attributed to aspecific product or service, a more significant challenge is how to assign or allocate indirect costs that cannot be linked to a specific product or service, but must be recovered in the aggregate through the prices charged to consumers.

Activity-based methodologies, such as Frontier's post-bankruptcy, virtual-separation approach, purportedly attempt to assign indirect costs in a more precise manner than its historical cost allocation methodology. Activity-based cost accounting requires businesses to review their activities to identify cost drivers (i.e., sources of costs or the reasons they are incurred). The cost drivers can then be analyzed to determine whether they do or do not add value to particular products or services. Activity-based cost accounting can provide businesses with more accurate understandings of their profit and costs centers for business decisions. Activity-based cost accounting also can be more subjective because the company will likely need to make judgment calls when assigning cost drivers to particular products or services, as opposed to assigning indirect costs based on a percentage of either direct cost or of revenues generated by the service. The

[4] Decl. of Carlin Adrianopoli in Support of Ch. 11 Pet. & First Day Motions at 136 (Apr. 15, 2020), https://cases.primeclerk.com/ftr/Home-DownloadPDF?id1=MTM5NDQ0Nw==&id2=0.
[5] DOC Information Request No. 1 (Oct. 22, 2021).

subjectivity in assigning cost is a concern since a company can make business decisions based on factors other than cost, and then allocate indirect cost in a manner that purports to justify those decisions.

According to Frontier, it previously assigned indirect costs to its respective jurisdictions as a percentage of revenue generated. Thus, for example, if state A generated 8% of Frontier's revenue it also was assigned 8% of the company's indirect costs. Frontier is now assigning indirect costs by determining how each jurisdiction contributes to thirty-seven identified categories that drive operating expenses at the cost center level. Frontier believes this activity-based approach provides more precision than the previously used revenue-based approach.[6]

Frontier's virtual separation report shows that Minnesota **[TRADE SECRET DATA BEGINS . . .** [redacted]

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[6] DOC Information Request No. 9(a) (Oct. 28, 2021).

[7] [redacted]

[redacted]

. . . TRADE SECRET DATA ENDS] It is difficult, and probably unwise, to draw broad conclusions from Frontier's virtual separation report. Figure 1 only provides a snapshot of Frontier's operating profitability and cash flow. It does not shed light on long-term trends or other

[8] Virtual Separation Report at 8.

considerations such as debt or non-cash expenses. It also cannot be used to independently evaluate future investment decisions because it only reflects past performance. Future business decisions and capital investment strategies will likely reflect additional factors such as financial and funding capabilities, legal and regulatory obligations, customer growth expectations, ability to capture market share, facility upgrade and expansion opportunities, and existing financial obligations.[9]

Despite these limitations, the virtual separation report provides useful insight into Frontier's relative performance from jurisdiction to jurisdiction. It also offers a starting place and context for more detailed analysis of Frontier's business prospects.

II. PROSPECTS FOR FUTURE INVESTMENT IN MINNESOTA.

The Commission's Order also asked interested parties to investigate any subsequent Frontier investment plans that will impact service in Minnesota and other issues relating to virtual separation. Frontier states that it "must make capital allocation decisions in a way to ensure that it can generate revenues and a return on its investment."[10] In investor updates, Frontier has shared evolving strategies for meeting these goals. The most detailed descriptions appear to be the June 2020 "Updated Base Case and Reinvestment Case Overview" and August 2020 "Network Modernization Plan Update."[11] Frontier, however, cautions that it continues to refine its analysis and strategy regarding capital deployment.[12]

Frontier's plans suggest that the company intends to prioritize fiber-to-the-premise investments in its largest operating states (CA, TX, FL, CT, WV, IL, NY, OH) ahead of its remaining jurisdictions. Frontier's filings also suggest that it will prioritize "brownfield clusters" with internal rates of return (IRRs) exceeding 30%.[13] Internal rate of return is a metric used to

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[9] DOC Information Request No. 5(a) (Oct. 22, 2021).
[10] DOC Information Request No. 6(a) (Oct. 22, 2021).
[11] Attach. A, Updated Base Case and Reinvestment Case Overview (June 17, 2020); DOC Information Request No. 14(a) (Nov. 19, 2021) (Attachment 1 – Network Modernization Plan Update (Aug. 12, 2020)).
[12] DOC Information Request No. 17(d) (Nov. 19, 2021).
[13] Updated Base Case and Reinvestment Case Overview at 15–16.

analyze and estimate the return generated from a particular investment. A "cluster" is geographic location with sufficient geographic density to support fiber-to-the-premise.[14] A "brownfield" for Frontier's purposes is a previously developed area where network facilities had previously been deployed.[15] **[TRADE SECRET DATA BEGINS . . .** [redacted]

[redacted] **. TRADE SECRET DATA ENDS]**

Beyond internal rate of return considerations, Frontier's decision to prioritize "brownfield" locations also may be a concern for some existing customers or potential customers.[19] In addition to brownfields, Frontier has considered making "Tower/Small Cell" and "Densification/Edge Out" investments. The "Tower/Small Cell" category describes service that relies on towers and antennae

[14] DOC Information Request No. 15(c), (d) (Nov. 19, 2021).
[15] DOC Information Request No. 17(a) (Nov. 19, 2021).
[16] Network Modernization Plan Update at 13.
[17] *Id.*
[18] DOC Information Request No. 10 (Oct. 28, 2021).
[19] Updated Base Case and Reinvestment Case Overview at 15–16.

to provide wireless connections. In low-density areas, this type of wireless service could be a desirable service option given the unavailability or unaffordability of fiber-to-the-premise. The "Densification/ Edge Out" category describes areas where Frontier could densify brown field builds and expand its fiber networks to areas adjacent to currently served locations.[20] This category likely captures customers living in exurban or "just outside of town" areas that might expect to have better service but are not able to access it. According to available documentation, however, both categories can expect to receive a fraction of the investment planned for brownfield locations.

III. COMPARISONS BETWEEN MINNESOTA AND NEIGHBORING STATES

In its Order, the Commission further recognized comparisons between Minnesota and Frontier's other operating states might inform our understanding of its operations and future plans.[21] As stated above, the subjectivity that exists in the virtual separation methodology can result in some states being favored over others. **[TRADE SECRET DATA BEGINS . . .** [redacted].

[20] *Id.* at 13; DOC Information Request No. 17(a) (Nov. 19, 2021).
[21] Order at 6.

[redacted]

[redacted]

[redacted]

[22] A customer obtaining voice and broadband service would appear in both columns. DOC Information Request No. 18(a) (Nov. 19, 2021).

[23] *Id.*

[redacted]

[redacted]

[redacted] **TRADE SECRET DATA ENDS]** Customers that have chosen to stop receiving telephone and/or broadband service from Frontier have presumably chosen to receive service from another provider. While serving fewer customers may justify a reduction in employees, to the extent there are insufficient staff resources to meet customer expectations for service quality, staff reductions may perpetuate the decline in customers retaining service with Frontier. Company decisions based on virtual separations will have an effect on investment decisions, the staffing needed to support new and existing infrastructure, and whether customers choose to retain Frontier as their service provider.

[24] DOC Information Request No. 19(a) (Nov. 19, 2021).

IV. "ImproveCo" versus "InvestCo" States

The Commission's Order finally asked interested parties to investigate Frontier's proposal to designate different state operations as an "InvestCo" or an "ImproveCo" state. In its bankruptcy filing, Frontier proposed to divide its state operations where it would conduct fiber deployments from those where it would perform broadband upgrades and operational improvements. According to the filing, areas where new fiber deployments were expected would be labeled "InvestCo," while other areas would be labeled "ImproveCo." Frontier states that it no longer uses the "InvestCo" and "ImproveCo" terminology and that it will "invest and improve its network operations throughout its operating territory including areas that are not identified for fiber-to-the-premise deployment."[25] Given this explanation, the "InvestCo" and "ImproveCo" terminology appears to have limited relevance to Frontier's future plans. Instead, as discussed above, it appears that Frontier is making investment decisions on a more granular basis.

CONCLUSION

The Department's investigation of the meaning and purpose of Frontier's "virtual separation" methodology, and its potential impact on Minnesota customers, provided insight into Frontier's investment decision making. However, the Department has not reached any conclusions on whether or not Frontier appropriately allocates indirect cost using its virtual separations methodology, given the time constraints of this investigation. To the extent that customer service quality issues arise going forward, it may be due to the lack of investment and inadequate staffing, and give cause for further investigation into Frontier's reliance on its virtual separation methodology for decision making. If, however, Frontier adequately invests in its Minnesota network and has adequate staffing to properly serve its customers, there would be no cause to investigate further. Thus, the Department has not found cause for the Commission to further

[25] DOC Information Request No. 6(a) (Oct. 22, 2021).

investigate Frontier's virtual separation methodology at this time, but believes the Commission should not hesitate to seek additional investigation if it learns that Minnesota customers are either not receiving adequate service, or are adversely and unfairly impacted by business decisions based on Frontier's indirect cost allocations.

Unless another party produces information to support further investigation, the Department recommends that the Commission adopt decision alternative Nos. 1 and 2 shown below:

1. Find that no further action is needed at this time and close the investigation on Frontier's virtual separation methodology.

2. Inform Frontier that the Commission will investigate further upon determining that Minnesota customers may be adversely or unfairly impacted by "virtual separation" or any subsequent investment plan.

3. Take other action that the Commission deems appropriate.

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Respectfully submitted,

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Figure 5. Distribution of Locations by Internal Rate of Return (IRR) Band[26]

[TRADE SECRET DATA BEGINS . . .

[redacted]

[26] DOC Information Request 14(a) (Nov. 19, 2021) (Attachment A).

[redacted]

. . . TRADE SECRET DATA ENDS]

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