BEFORE THE NEW HAMPSHIRE
PUBLIC UTILITIES COMMISSION

Verizon New England Inc., Bell Atlantic	)	
Communications Inc., NYNEX Long Distance	)	
Company, Verizon Select Services Inc. and	)	
FairPoint Communications, Inc.	)	Docket No. DT 07-011
Joint Petition for Authority to Transfer Assets	)	
and Franchise to FairPoint Communications, Inc.	)	

PUBLIC
PREFILED DIRECT TESTIMONY OF DAVID BREVITZ

ON BEHALF OF THE
OFFICE OF CONSUMER ADVOCATE

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I. <u>Introduction</u>

A. Qualifications

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is David Brevitz. My business address is Brevitz Consulting Services, 3623 SW Woodvalley Terrace, Topeka, Kansas, 66614.

Q. BY WHOM AND IN WHAT CAPACITY ARE YOU EMPLOYED?

A. I am an independent consultant serving state regulatory commissions, Attorney's General offices, and consumer organizations. I am testifying on behalf of the New Hampshire Office of Consumer Advocate ("OCA").

Q. DO YOU HAVE SPECIFIC EXPERIENCE, EXPERTISE AND DIRECT KNOWLEDGE REGARDING THE SUBJECTS WHICH ARE CONTAINED IN YOUR TESTIMONY?

A. Yes. Over my twenty-six year career I have worked on numerous telecommunications dockets and cases, as the marketplace and regulatory environment has changed to the current date. In that time span there have been numerous milestone events, most recently including the Federal Telecommunications Act of 1996, the rise and fall of CLEC competition, attempted development of "one stop shop" service bundles for consumers, deregulation, and continued partnerships, consolidations and acquisitions in the telecommunications industry leading to greater market concentration. I have recent experience, as discussed further below, in evaluation of proposed telecommunications spin offs and mergers, designed to be "tax free", including under the reverse Morris trust framework.

Q. PLEASE STATE YOUR EXPERIENCE AND PROFESSIONAL QUALIFICATIONS.

A. My career has been in telecommunications. My interest in telecommunications began while studying at the Institute of Public Utilities in the Economics Department at Michigan State University. While at Michigan State, I earned an undergraduate degree in Justice, Morality and Constitutional Democracy from James Madison College (a residential college at MSU) and an MBA in Finance (1980). Since that time, I have worked on a variety of issues beginning with the detariffing of inside wiring and CPE (customer premise equipment) and changes to jurisdictional separations to the more current issues of competition and deregulation, substitute services and intermodal competition, alternative regulation plans, bundled services, access charges, price floors and imputation, jurisdictional cost allocations including direct assignments, and requirements of the Telecommunications Act of 1996 including competition, interconnection requirements, resale, unbundled elements, TELRIC/cost studies, and Section 271 applications.

Prior to entering the consulting field, I served as Chief Telecommunications Analyst for the Kansas Corporation Commission from late 1984 to early 1987, and then served as

Director-Regulatory Affairs of Kansas Consolidated Professional Resources (KCPR)-an organization serving Kansas independent telephone companies. In February 1994, I began work as an independent consultant in telecommunications, serving state utility commissions and consumer counsels. I currently serve on the Kansas Corporation Commission Advisory Staff on telecommunications matters.

Since beginning work as an independent consultant, I have performed a variety of assignments and tasks related to formulation of telecommunications policy and cost study review for many state utility commission projects, including working on behalf of the Vermont Department of Public Service in the 2001 “271” Review, and the 1999 and 2004-2005 Verizon Vermont Alternative Regulation cases. I also have served as a consultant to the Maine Office of the Public Advocate (OPA), including work on the 2001 Maine “271” case. I currently serve as an expert to the Maine OPA in the Maine PUC’s counterpart to this proceeding. As a result of these assignments, I have current expertise regarding competitive markets issues in telecommunications, and the detailed tasks associated with implementing the federal Telecommunications Act of 1996, including pricing and costing, interconnection, network unbundling, resale, number portability. A full description of my background and experience in telecommunications regulation is provided on Exhibit DB-P-1.

Q. DO YOU HAVE RECENT PREVIOUS EXPERIENCE WITH "SPIN OFF" OF LOCAL TELECOMMUNICATIONS OPERATIONS?

A. Yes. I completed work as the project team leader for the Bureau of Consumer Protection within the Nevada Office of Attorney General in which I assessed and addressed financial and policy issues pertaining to the proposed spin-off of LTD Holding Company (later named "Embarq") from Sprint Nextel Corporation.[1] Subsequent to that I assisted the Advisory Staff of the Kansas Corporation Commission in its evaluation of the LTD Holding Company ("Embarq") spin-off from Sprint/Nextel.[2] Following that task, I assisted the Office of the Attorney General of Kentucky in its evaluation of the proposed spin off of Alltel's local operations and immediate merger with and into Valor Communications (later named Windstream), including filing testimony containing recommendations regarding treatment of the proposed transaction.[3] As a result of these cases, I have direct knowledge and experience of how companies evaluate these types of transactions, documents that the companies and their investment advisors generate and

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[1] Application of Central Telephone Company - Nevada, d/b/a Sprint of Nevada ("Central Telephone"), for approval for the change of control of Central Telephone from Sprint Nextel Corporation to LTD Holding Company, Docket No. 05-8032. I did not file testimony in this case since a stipulation among the parties was reached.

[2] In the Matter of the Application of Sprint Nextel Corporation and LTD Holding Company for Approval of the Transfer of Control of United Telephone Company of Kansas, United Telephone Company of Eastern Kansas, United Telephone Company of Southcentral Kansas, Sprint Missouri, Inc., d/b/a United Telephone Company of Southeastern Kansas and Sprint Long Distance, Inc. From Sprint Nextel Corporation to LTD Holding Company (Embarq), Docket No. 06-SCCC-200. I did not file testimony in this case as it was resolved largely by stipulation.

[3] In the matter of Application for Approval of the Transfer of Control of Alltel Kentucky, Inc. and Kentucky Alltel, Inc., Case No. 2005-00534, April 21, 2006.

produce as part of the process, and regulatory issues pertaining to such proposed transactions.[4]

Q. DO YOU HAVE OTHER RELEVANT QUALIFICATIONS?

A. Yes. In 1984 I was designated as a Chartered Financial Analyst by the Institute of Chartered Financial Analysts ("ICFA"), which later became the CFA Institute. The CFA Institute is the organization which has defined and organized a body of knowledge important for all investment professionals. The general areas of knowledge are ethical and professional standards, accounting, statistics and analysis, economics, fixed income securities, equity securities, and portfolio management.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to analyze and address financial and public interest considerations associated with the proposed disposition of Verizon New England local exchange operations in three states (New Hampshire, Maine and Vermont), via a spin off of those operations and subsequent merger with FairPoint Communications, Inc. ("FairPoint") on behalf of the OCA. These issues would be included in Topic Group I, Financial and Transactional issues.[5]

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[4] Also as a result of this experience, I expected "standard" types of documents to be readily available for review and produced by the companies as a result of the first round of discovery. In contrast to the Embarq and Windstream cases, that did not prove to be the case here, as I discuss later in my testimony.

[5] See Order 24,733, March 16, 2007, at pp. 5 and 19; and Staff Report of Technical Session held on February 27, 2007, dated March 5, 2007.

Q. BEFORE TURNING TO THE SUBSTANCE OF YOUR TESTIMONY, PLEASE EXPLAIN THE FOUR LEVELS OF REDACTION IN YOUR TESTIMONY.

A: Due to restrictions on disclosure required by FairPoint and Verizon, the OCA was required to create four different versions of its testimony. In order of least protected to most, these versions are called: Public, Confidential, Highly Confidential Level 2, and Highly Confidential Level 1. Exhibits and Attachments are also categorized and redacted accordingly.

The text, exhibits and attachments that are flagged as "Public" corresponds with the fully redacted version of my testimony. I denote "Public" exhibits as "DB-P-#".

The text, exhibits and attachments that are flagged as "Confidential" correspond with FairPoint's categorization of "confidential" and Verizon's categorization of "note 1". According to the Joint Petitioners, they disclosed "Confidential" information only to the parties who signed the Protective Agreement or Schedule 1. I denote "Confidential" exhibits as "DB-C-#".

The text, exhibits and attachments that are flagged as "Highly Confidential" denote a higher level of protection than "Confidential". "Highly Confidential Level 3" is the lowest level of protection among the three "Highly Confidential" levels. Due to the fact that the testimony and exhibits do not contain any information categorized by FairPoint as “Highly Confidential Level 3” or Verizon as “note 2”, the OCA did not create “Highly Confidential Level 3” or “Note 2” versions of my testimony.

The text, exhibits and attachments that are flagged as “Highly Confidential Level 2” corresponds with FairPoint’s categorization of “Highly Confidential Level 2” and Verizon’s “note 3”. The Joint Petitioners disclosed “Highly Confidential Level 2”/ “note 3” information only to Staff, attorneys and a consultant, Randall Barber, for Labor, and the OCA and the OCA’s consultants. I denote “Highly Confidential Level 2” exhibits as “DB-HCL2-#”.

The test, exhibits and attachments that are flagged as “Highly Confidential Level 1” correspond with FairPoint’s categorization of “Highly Confidential Level 1”. Verizon had no comparable category. “Highly Confidential Level 1” is the highest level of protection and fully unredacted. According to FairPoint, it disclosed most of the “Highly Confidential Level 1” information available only to Staff and its consultants, and the OCA and its consultants. I denote “Highly Confidential Level 1” exhibits as “DB-HCL1-#”.

B. Summary of Conclusions and Recommendations

Q. PLEASE SUMMARIZE YOUR RECOMMENDATIONS AND CONCLUSIONS TO THE COMMISSION IN THIS CASE.

A. I recommend that the Commission deny the application as filed for several reasons. It is my conclusion that the spin-off and merger transactions are ill-conceived from the standpoint of New Hampshire ratepayers. FairPoint is in very weak financial shape entering the transaction, and is little improved according to its projections if the proposed transaction takes place. Further, FairPoint's financial projections are unverifiable and contain flawed assumptions. The Commission should not rely on FairPoint's financial projections in determining whether the proposed new company is financially viable.

The financial weakness of FairPoint exposes nearly all of the state's telecommunications ratepayers to a significant potential of receiving service from a distressed utility. As a "high debt/high dividend" local exchange carrier (LEC), FairPoint would be in a very poor position to deal with any significant adversity, which can come from several crucial and sizeable exposures to events.

FairPoint's risky financial structure exposes it, along with the customers it proposes to serve, to an unwarranted level of risks from (not necessarily in any order):

- competitive line losses (especially cable telephony);

- increasing interest rates;
- fundamental changes in the financial markets such that “high yield” or “junk bond” debt can no longer be obtained at historically low margins over safer investments;
- fundamental changes in the financial markets such that “high yield” rural LECs are no longer favored in the marketplace;
- cost, time and functionality difficulties in developing, integrating and installing interrelated “back office” operating systems (for example, the recent Capgemini Work Order #2);
- work stoppages or slow-downs from difficult labor relations;
- greater than expected capital expenditures to rectify service quality problems not known in detail until after closing;
- labor and/or facilities quality/capacity of service difficulties which slow down projected pace of revenue gain (e.g., DSL);
- operating expenses that cannot be maintained to essentially a zero percent growth, year to year;
- failure of other line item projections to come in at projected levels in actuality (e.g., the CLEC business); and
- failure to achieve the overall savings expected compared to Verizon New England’s costs (“synergies”).

Q. IF THE COMMISSION IS INCLINED, AGAINST YOUR RECOMMENDATION, TO APPROVE THE APPLICATION, SHOULD IT TAKE ANY PRELIMINARY STEPS BEFORE MAKING A DETERMINATION OF WHETHER TO APPROVE THE APPLICATION?

A. Yes. As I discuss in detail in my testimony, the Commission should at a minimum require Verizon New England and FairPoint to take the following additional steps before it determines whether to approve the application:

1. Verizon New England must provide access to detailed plant and engineering records and resources to FairPoint, and FairPoint must review and rely on those records in order to obtain a firm basis for its capital expenditures budgets and projections, relating to the DSL build out, and any other capital expenditure needs that would be prudent based on the detailed information.
2. FairPoint must incorporate revised capital expenditures budgets and projections from 1, above, into its financial modeling and projections for the proposed combined company, and retain and provide supporting documents for the revised capital expenditures budgets and projections.
3. FairPoint must be required to provide the Commission with its "current view" on the business of the combined company, including information from 2, above, with data that can and should be considered a reliable predictor of future operating results.

Q. IF THE COMMISSION IS INCLINED, AGAINST YOUR RECOMMENDATION, TO APPROVE THE APPLICATION AFTER THE COMPANIES TAKE THESE ADDITIONAL STEPS, SHOULD IT DO SO ONLY WITH STRONG CONDITIONS?

A. Yes. As I discuss in detail in my testimony, the Commission should at a minimum condition its approval as follows:

1. In order to ensure that the financial viability of the proposed transaction not depend on local rate increases subsequent to close, FairPoint should agree to no local exchange rate increases prior to a calendar year 2012 test period.
2. FairPoint should agree to reduce its dividend to permit cash to be used for debt repayment, DSL buildout, and other capital expenditures and operating needs.
3. FairPoint should agree that its New England subsidiaries shall not assume responsibility for the liabilities of FairPoint or its successor directly or indirectly as guarantor, endorser, surety, through pledging of assets or stock, or otherwise.
4. FairPoint should agree that any additional costs of non-investment grade debt (rated below BBB-) are not to be recovered from New Hampshire ratepayers.
5. FairPoint should agree that New Hampshire ratepayers shall not bear, either directly or indirectly, any costs, liabilities or obligations incurred in connection with the proposed spin off and merger transactions. In other words, New

Hampshire ratepayers should not unnecessarily be subjected to any risk of the transaction.

6. To ensure that New Hampshire consumers receive the benefit of the system development integration and implementation undertaken by FairPoint due to this proposed transaction, FairPoint should agree that the management, billing and operational support systems platform ("System") developed in concert with this proposed transaction is owned by its New Hampshire, Maine and Vermont subsidiaries or their successors. FairPoint should agree that any regulated operations in New Hampshire, Maine or Vermont shall not be charged any markup for margin over cost for allocated costs of development or use of this System. FairPoint should agree that charges for use of the System by any existing or future company operation in any other state shall inure to the benefit of the ratepayers in Vermont, New Hampshire and Maine and offset or reduce costs charged to any FairPoint regulated operation in these three states. FairPoint should agree that cost development enhancement that is not directly related to benefits for New Hampshire, Maine and Vermont shall not be charged or assessed to ratepayers in these three states directly or indirectly.

7. FairPoint should agree that any compensation, remuneration, or other payment to any officer, executive or board member of FairPoint as a consequence of, or related to the consummation of this transaction, shall be paid only by way of stock

or stock option redeemable no sooner than 2012. In other words, said individual will bear similar risks of the viability of the surviving companies as the ratepayers and new shareholders.

8. FairPoint should agree to notify the Commission and parties to this docket of any downgrading of FairPoint's or any subsidiary's debt within seven days of such downgrade, and will include with such notice the complete report of the issuing bond rating agency. In addition, FairPoint should agree that it shall report whether the conditions driving the change in credit rating are anticipated to result in a short-term or long-term deterioration of credit metrics, and shall address FairPoint's liquidity and provide an explanation of FairPoint's financial condition that is verified and attested to by a corporate officer.
9. FairPoint should agree that it shall provide to the Commission and the parties to this docket any credit rating agency reports following the close of the transaction within 15 days of issuance by such agency.
10. FairPoint should finalize a detailed broadband deployment plan and agree to investment in wireline based high speed internet access capabilities in this jurisdiction, according to that plan as finalized by FairPoint.
11. FairPoint should agree that it shall employ and continue to employ adequate resources to meet the quality of service standards established by the Commission.

12. FairPoint should agree to any other conditions to which FairPoint has agreed to within this proceeding.
13. FairPoint should agree to any other conditions which are imposed by other state commissions, or otherwise agreed to by FairPoint.

In addition to the above recommended conditions, I urge the Commission to also consider other conditions proposed by Susan M. Baldwin on behalf of the OCA, or other parties and Staff.

<u>II. The Application and Proposed Transaction</u>

A. Overview of Proposed Transaction

Q. PLEASE SUMMARIZE YOUR UNDERSTANDING OF THE APPLICATION IN THIS MATTER.

A. Essentially, Verizon New England and FairPoint ("Joint Applicants") seek approval of a transaction whereby FairPoint acquires the assets and customers related to Verizon New England's local exchange businesses in New Hampshire, Vermont, and Maine. It is a complex transaction that is accomplished using several key transaction documents (each of which includes referenced exhibits and attachments) which have been provided by the Joint Applicants as follows:

- Agreement and Plan of Merger (the Merger Agreement);
  - Employee Matters Agreement;

    - Tax Sharing Agreement;
    - Master Services Agreement with Capgemini;
    - Termination Agreement;
- The Distribution Agreement;
    - Publishing Agreement;
    - Intellectual Property Agreement; and,
- Transition Services Agreement.
- Other agreements and contracts are referenced within these documents and have been provided, but under confidential protection.

The proposed transaction is to be accomplished in a series of steps, many of which occur essentially simultaneously. Verizon New England creates subsidiaries specifically to hold assets, liabilities, customer relationships and related service obligations or contracts. One subsidiary is "Telco", to which will be transferred the ILEC assets, liabilities and customers from Verizon New England's operations in New Hampshire, Maine, and Vermont. FairPoint anticipates that all current Verizon New England employees in the three states will continue employment with FairPoint. Another subsidiary is "Newco" which receives assets, liabilities and customers related to Verizon New England's unregulated businesses in New Hampshire, Maine and Vermont. "Spinco" is a third entity, formed by Verizon Communications, that receives the stock in "Telco" and the non-regulated businesses associated with "Newco".

FairPoint and "Spinco" receive cash proceeds from the financing associated with the "commitment letter" and related documents. "Spinco" uses part of the proceeds to pay a special dividend to Verizon Communications in an amount equal to the tax basis that Verizon Communications has in the "Spinco" shares (approximately $900 million). Another part of the cash proceeds is used to refinance and replace existing FairPoint debt. Furthermore, "Spinco" provides its debt securities to Verizon Communications to be used to replace existing Verizon Communications debt, effectively permitting Verizon Communications to reduce its debt by approximately $800 million. The "Spinco" debt obligations become obligations of FairPoint.

"Spinco" stock is distributed by Verizon Communications to its shareholders, and then exchanged into FairPoint stock in the ratio of one share of FairPoint stock for each 55 shares of Verizon Communications stock held as of the record date. At the conclusion of the distribution and merger transactions, current Verizon Communications shareholders will own approximately 60% of the combined enterprise via FairPoint stock, and current FairPoint shareholders will own approximately 40%. This proportion will only hold at the instant in time the transaction is accomplished, since trading of FairPoint stock will occur immediately after and change the composition of the shareholder base with each trade.

Q. DOES VERIZON NEW ENGLAND CURRENTLY SERVE MOST OF THE THREE STATE AREA?

A. Yes. "Spinco currently serves a territory addressing approximately 87% of the households and approximately 73% of the geography of Maine, New Hampshire, and Vermont."[6]

Q. WHAT IS THE INDICATED VALUE OF THE TRANSACTION TO VERIZON COMMUNICATIONS AND ITS SHAREHOLDERS?

A. The indicated value is $2.7 billion, comprised of $1 billion in FairPoint equity value received by Verizon Communications' shareholders, and $1.7 billion in proceeds received by Verizon Communications by a combination of the special cash dividend (approximately $900 million) and the exchange of FairPoint debt for Verizon Communications debt (approximately $800 million). FairPoint will issue approximately 53.8 million shares of its common stock to Verizon Communications' shareholders.[7]

Q. WHAT IS THE SCALE OR COMPARISON OF FAIRPOINT'S EXISTING OPERATIONS AND THE VERIZON NEW ENGLAND PROPERTIES THAT FAIRPOINT PROPOSES TO ACQUIRE?

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[6] Exhibit DB-P-2, FairPoint Communications Inc., Amendment No. 4 to Form S-4 Registration Statement Under the Securities Act of 1933, filed with the United States Securities and Exchange Commission ("SEC") on July 2, 2007 ("FairPoint Amendment No. 4 to S-4"), at page 24.

[7] See Exhibit DB-P-3, FairPoint Communications Transaction Announcement, January 16, 2007, at page 10.

A. Comparative metrics[8] follow:

	FairPoint	Verizon NE	Multiple
Access Line Equivalents	308,858	1,713,251	5.55
Residence Access Lines	194,002	982,953	5.07
Business Access Lines	57,761	393,607	6.81
Broadband Subscribers	57,095	176,969	3.10
Revenue	$ 263,000,000	$ 1,206,000,000	4.59
EBITDA	$ 135,000,000	$ 431,000,000	3.19

Q. WHAT DO THESE METRICS INDICATE?

A. These metrics point out the substantial relative size differences between FairPoint and the properties that it proposes to acquire. The relative size difference is such that FairPoint cannot operate the acquired properties with its existing internal "back office" management and operational support systems and personnel. FairPoint must undertake very extensive system development, integration and implementation, and hire 675 or more additional employees.[9]

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[8] See Exhibit DB-P-3, FairPoint Communications Transaction Announcement, January 16, 2007, at pages 12 and 15.
[9] Exhibit DB-P-4, "FairPoint promises 675 new jobs if Verizon deal goes through, Business Review, July 6, 2007.

Q. THE TERM "EBITDA" IS USED IN THE TABLE ABOVE. WHAT IS "EBITDA", AND WHY IS IT USED FREQUENTLY IN DOCUMENTS IN THIS CASE?

A. "EBITDA" stands for earnings (or net income) before subtraction of interest expense, taxes, depreciation and amortization. EBITDA is an accounting-related measure based on the income statement that is used to compare profitability, assess operating profitability, and eliminates the effects of how a business is financed. EBITDA is operating income for a period with depreciation expenses and amortization expenses added back in order to approximate cash earnings.

As stated by FairPoint, "FairPoint believes EBITDA allows a standardized comparison between companies in the industry, while minimizing the differences from depreciation policies, financial leverage and tax strategies."[10] EBITDA is the starting place for cash flow analyses in FairPoint's projections, and it is also a crucial measure utilized by both Verizon New England and FairPoint, and their respective investment advisors during the evolution of the proposed transaction. Verizon New England and FairPoint in their analyses both start with calculation of EBITDA, then deduct other uses of cash such as capital expenditures, taxes, interest and principal payments, and dividends .

[10] Exhibit DB-P-5, FairPoint Communications Form 8-K filed with the SEC on August 3, 2006, at page 7.

Q. ARE "CUSTOMERS" OR "CUSTOMER RELATIONSHIPS" TANGIBLE ASSETS WHICH WOULD NECESSARILY REMAIN WITH FAIRPOINT FOLLOWING THE PROPOSED TRANSACTION?

A. No. "Customers" and "customer relationships" are not tangible assets for FairPoint or Verizon New England. These customers may or may not remain with FairPoint following the proposed transaction, and to the extent customers do remain, their duration would vary.

Q. PLEASE SUMMARIZE YOUR UNDERSTANDING OF THE LEGAL REQUIREMENTS AFFECTING YOUR REVIEW OF THIS APPLICATION.

A. My understanding is that the Commission must find that the proposal is "in the public good" (i.e., provides a public benefit) in order to approve the application as requested by Verizon New England and FairPoint Communications.

Q. DO VERIZON NEW ENGLAND AND FAIRPOINT MAKE A NUMBER OF ASSERTIONS REGARDING THE FEATURES AND BENEFITS OF THE PROPOSED TRANSACTION?

A. Yes. Throughout their testimony and discovery responses, FairPoint and Verizon New England assert a number of features and benefits of the proposed transaction. For purposes of my testimony, the primary assertions I respond to are those regarding the financial "strength" of the proposed combined companies, and the extent to which financial projections provided by FairPoint should be accepted unchanged by the Commission in making its determinations. In addition, I will address the implications of the Reverse Morris Trust structure for this proposed transaction,[11] the adequacy of the process by which FairPoint was selected by Verizon Communications for this proposed transaction, the nature of risks associated with the proposed disposition of the Verizon New England operations to FairPoint, and objectives and motivators for this proposed transaction for both Verizon Communications and FairPoint. All of these topics fall within Group I, Financial and Transactional issues.

B. FairPoint's History and Objectives

Q. PLEASE OUTLINE THE CORPORATE HISTORY OF FAIRPOINT.

A. FairPoint was incorporated in 1991, and made its first acquisition in 1993. FairPoint characterizes itself as an "acquisition company", and focuses on "small and mid-size,

[11] See full discussion of Reverse Morris Trusts in Section II. D.

privately and publicly owned local exchange carriers, as well as properties sold by the regional Bell operating companies”.[12] FairPoint has acquired 35 small telephone companies, 31 of which it continues to operate. FairPoint currently operates in 18 states.

After acquisitions such as the above, FairPoint has sought to centralize functions such as sales and marketing, operations, network planning, accounting and customer service. This implies eliminating costs for functions at the acquired company, and performing those functions elsewhere among the FairPoint affiliates. The majority of communities served have fewer than 2,500 access lines. Since the acquired companies are rural in nature, FairPoint’s revenue stream includes federal universal service funds. The top four states in terms of access lines are Maine, Florida, New York and Washington. FairPoint currently operates in New Hampshire via a small cross-border operation of a FairPoint company in Maine, with less than 500 access lines.

FairPoint accomplished an Initial Public Offering of its common stock in February 2005, and has been listed on the New York Stock Exchange. FairPoint had an income deposit security offering which was withdrawn in 2004.

[12] Exhibit DB-P-6, FairPoint Corporate Fact Sheet.

Q. HOW WAS FAIRPOINT FINANCED PRIOR TO THE IPO?

A. FairPoint has generally been financed with institutional and bank debt, and private equity. Some of the debt has been secured by the common stock of the Company. Its debt leverage levels have been consistently high.

Q. AFTER THE FEBRUARY 2005 IPO, HOW CAN FAIRPOINT'S FINANCIING BE CATEGORIZED?

A. After the IPO, FairPoint established its dividend which is currently indicated to be $1.59 per share per year. This level of dividend equates to approximately 8% yield. Accordingly, FairPoint can be considered to be a "high debt/high dividend" entity. Its overall risk profile is high. Interest payments associated with the high debt are a very significant outflow of cash, as are dividend payments. ***BEGIN CONFIDENTIAL***

***END CONFIDENTIAL ***.[13]

The dividend level is analyzed by comparing the aggregate dividend amount to the amount of cash available to pay dividends (CAPD), and computing a ratio or percentage.

[13] See Exhibit DB-C-1, FairPoint's first and second supplemental replies to OCA GI 1-41, and Exhibit DB-C-2, JP Morgan report dated February 22, 2006, page 1 (CFPNH 0948); JP Morgan report dated May 4, 2006, page 1 (CFPNH 0974); JP Morgan report dated August 2, 2006, page 1 (CFPNH 0989); JP Morgan report dated December 16, 2005, pages 1-2 (CFPNH

FairPoint's pre-merger payout ratio is 87%.[14] CAPD is the cash left after paying all cash operating expenses, capital expenditures, interest and taxes.

Q. WHAT ARE FAIRPOINT'S FINANCIAL OBJECTIVES OR ANTICIPATED BENEFITS FROM THIS TRANSACTION?

A. As an "acquisition company", FairPoint must continuously generate the cash flow necessary to fund the operations of its companies, and its financial obligations for its debt and equity. Since the IPO, *****BEGIN CONFIDENTIAL*****

*****END CONFIDENTIAL*****. "What [FairPoint will] accomplish with this merger might have taken [it] five years or longer by acquiring smaller operating companies and integrating them into FairPoint."[15]

FairPoint's considerations for the proposed transaction include:

*****BEGIN HIGHLY CONFIDENTIAL*****

1050-1051) and 13-17 (CFPNH 1062-1066); Goldman Sachs report dated November 4, 2005, page 1 (CFPNH 1428); Morgan Stanley report dated November 3, 2006, page 1 (CFPNH 2579).

[14] See Exhibit DB-P-3, FairPoint Communications Transaction Announcement, January 16, 2007, at page 12.

[15] Exhibit DB-P-7, FairPoint Investment Communication, January 16, 2007, at page 2.

END HIGHLY CONFIDENTIAL.[16]

Without the proposed transaction, FairPoint's prospects are dire. "In reaching its recommendation, FairPoint's board of directors considered the future prospects of FairPoint on a standalone basis relative to those that would result from the merger."[17] Without this transaction, projected debt leverage is shown by Lehman Brothers[18] as:

	2008	2009	2011	2013
FairPoint "Acquisition Case" (Smaller Acquisitions)	4.8x	4.9x	4.8x	4.9x

[16] See Exhibits DB-HCL2-1 and DB-HCL2-2, FairPoint's reply to OCA GI 1-8 and FairPoint's Hart-Scott-Rodino (HSR) Attachment 4(c)-9, CEO Conference July 25, 2006 "Highly Confidential" – FairPoint personnel only**,** at page 1 (CFPNH HSR 0212). On May 4, 2007, the Maine Public Utilities Commission made public the titles of FairPoint's and Verizon's HSR documents.

[17] Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at page 64.

[18] See Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at page C-2-1, "New Base Case".

FairPoint "Status Quo"	4.6x	4.8x	5.3x	6.0x

Through this proposed transaction with Verizon New England, FairPoint seeks to improve its financial position by augmenting its "free" cash flow. FairPoint projects that its leverage ratio will decline from approximately 4.5x to 4.1x (net debt as a multiple of EBITDA, or earnings before interest, taxes, depreciation and amortization), and that its dividend payout ratio will decline from 87% to 60-70%.[19]

Q. DOES FAIRPOINT INTEND TO CONTINUE ACQUISITIONS SUBSEQUENT TO THIS PROPOSED TRANSACTION?

A. Evidently, FairPoint intends to continue with acquisitions.[20]

[19] See Exhibit DB-P-3, FairPoint Communications Transaction Announcement, January 16, 2007, at page 12.
[20] See, e.g., Exhibit DB-P-8, FairPoint Communications Inc., Amendment No. 5 to Form S-4 Registration Statement under the Securities Act of 1933, filed with the SEC, July 10, 2007 ("FairPoint Amendment No. 5 to S-4"), at page 40.

Q. AS AN "ACQUISITION COMPANY", FAIRPOINT HAS ACQUIRED 35 COMPANIES. HOW SIMILAR IS THIS PROPOSED TRANSACTION TO FAIRPOINT'S PREVIOUS ACQUISITIONS?

A. The proposed transaction is <u>completely different</u> from FairPoint's previous acquisitions. The material dissimilarity is that the previous 35 acquisitions were much smaller rural independent LECs, while this proposed acquisition is to acquire RBOC operations covering three states.

RBOCs typically serve 80-85% of a state's population and comprise the technical hub in the state for network services and Enhanced 911. Verizon New England serves approximately 87% of the households in the three states.

Integration of smaller independent LECs, which were originally under REA funding and standards, is accomplished in a much different fashion than the integration necessary from this proposed transaction. The nature (and quality) of a smaller rural LEC's operations would tend to be more visible, while RBOC operations (and quality) are less transparent due to the national scale of the company, allocations from centralized service organizations, and variations in allocations of capital to different lines of business and jurisdictions. In this proceeding, for example, <u>*****BEGIN HIGHLY CONFIDENTIAL *****</u>

<u>**END HIGHLY CONFIDENTIAL</u>**.

For previous rural LEC acquisitions, FairPoint could integrate the new company into existing FairPoint operations and systems, or maintain stand-alone functions as desirable. For the proposed acquisition, FairPoint cannot integrate the three state operations into existing back office operational and management systems, but instead must create them from the ground up. In previous rural LEC acquisitions, FairPoint likely could have realized savings from the combination of two companies, while for this proposed transaction FairPoint must build up and integrate costs, systems and personnel. In sum, this transaction represents a complete shift in thinking and approach for FairPoint, and thus heightens "execution risk."[21]

C. Verizon Communications' Objectives

Q. WHAT IS YOUR VIEW OF VERIZON COMMUNICATION'S RATIONALE AND MOTIVATION FOR THE PROPOSED TRANSACTION?

A. In general, "Verizon believes the proposed transaction with FairPoint … allows Verizon to focus more intently on its operations in other markets."[22]

> Verizon said in May [2006] it was putting lines in New Hampshire, Vermont and Maine on the block as well as lines in several Midwestern states. Any Midwestern deal appears stalled for now. Verizon, of New

[21] For further discussion of "execution risk," see section V.A.
[22] Smith Testimony on behalf of Verizon New England, page 2, line 21.

> York, is looking to shed land lines that are expensive to maintain as it upgrades its network with fiber and starts selling Internet-based services rather than focusing on traditional phone service. Many of the more than 1.6 million New England lines are in rural areas and are difficult to service.[23]

The Northern New England states are not a priority to Verizon Communications from an operational and financial standpoint, and probably have not been for some time, as indicated by the lack of significant deployment of FiOS[24] in the three states (although uniquely among the three states, New Hampshire has had some recent deployment of FiOS, which has since stopped), and recurrent service quality issues and problems over the past several years. Verizon's objectives would include obtaining the reduced debt leverage that is obtained from the transaction, and ending the necessity of deploying capital and other resources in the three states. Achieving these objectives permits deployment of greater resources to the corporate priorities of FiOS and wireless services, and perceived higher growth opportunities. "Verizon's various strategic opportunities have required it to prioritize the demands on its capital, and it has chosen to divest these exchanges in order to accommodate those competing needs."[25]

[23] Exhibit DB-P-9, "Verizon Considers FairPoint Bid for Land Lines in New England", The Wall Street Journal, August 19, 2006.
[24] "FiOS" is the fiber to the premise offering of Verizon that is being supported by fiber network buildout in locations across the country. "Verizon's broadband fiber-to-the-premises network—over which customers receive FiOS internet and FiOS TV services—passed a total of nearly 6.8 million premises by the end of the first quarter 2007, toward a year end target of 9 million." Exhibit DB-P-10, Verizon Investor Quarterly, First Quarter 2007, April 30, 2007, page 8.
[25] See Exhibit DB-P-11,Verizon's and FairPoint's "Opposition to Petitions to Deny", WC Docket No. 07-22, before the Federal Communications Commission, May 7, 2007, at page 3 (FPNH 0775).

Q. WHAT OBJECTIVES WERE IMPORTANT TO VERIZON AS ILLUSTRATED BY THE HSR DOCUMENTS WHICH YOU REVIEWED?[26]

A. Verizon is clearly motivated by these factors: **[**<u>*****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****</u>

<u>*****END HIGHLY CONFIDENTIAL HSR INFORMATION *****</u>;[27]

- <u>*****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION *****</u>

[26] Some of Verizon's HSR documents <u>*****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION**</u> <u>*****END HIGHLY CONFIDENTIAL HSR INFORMATION *****</u> were provided to the OCA.

[27] See Exhibits DB-P-12 and HCL2-3, Verizon's supplemental reply to Labor GI 1-13(h) and Verizon HSR Attachment 4(c)-13, <u>*****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION**</u> <u>*****END HIGHLY CONFIDENTIAL HSR INFORMATION *****</u>

__**END HIGHLY CONFIDENTIAL HSR INFORMATION**__[28]

- ***__**BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****__

__**END HIGHLY CONFIDENTIAL HSR INFORMATION**__.[29]

Subsequently, Verizon evaluated ***__**BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****__

[28] See Exhibit DB-HCL2-3, Verizon HSR Attachment 4(c)-13, ***__**BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****__ ***__**END HIGHLY CONFIDENTIAL HSR INFORMATION*****__

[29] See Exhibit DB-HCL2-3, Verizon HSR Attachment 4(c)-13, ***__**BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****__ ***__**END HIGHLY CONFIDENTIAL HSR INFORMATION*****__

__**END HIGHLY CONFIDENTIAL HSR INFORMATION**__.[30]

Later, Verizon linked the following characteristics to the Northern New England properties: __*****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****__

__*****END HIGHLY CONFIDENTIAL HSR INFORMATION*****__.[31]

In the __*****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****__

[30] See Exhibit DB-HCL2-4, Verizon's HSR Attachment 4(c)-10, __*****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****__
19. ***__**END HIGHLY CONFIDENTIAL HSR INFORMATION*****__

[31] See Exhibit DB-HCL2-5, Verizon HSR Attachment 4(c)-8, __*****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****__ ***__**END HIGHLY CONFIDENTIAL HSR INFORMATION*****__

*END HIGHLY CONFIDENTIAL HSR INFORMATION***.** [32]

Related materials state:

*BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****

*END HIGHLY CONFIDENTIAL HSR INFORMATION*****. [33]

Q. WHAT REASONS DID VERIZON COMMUNICATIONS STATE BEFORE THE SEC FOR THE SPIN-OFF AND MERGER?

A. Verizon’s board of directors considered a “wide variety of factors in deciding whether to approve the spin-off and the merger with FairPoint.”[34] These factors included:

- Verizon's belief that its strategic position would be enhanced by the transactions because Verizon's current strategy is focused on delivering

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[32] See Exhibit DB-HCL2-6, Verizon HSR Attachment 4(c)-3, **_***BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION***_**

_***_ **_END HIGHLY CONFIDENTIAL HSR INFORMATION***_**

[33] See Exhibit DB-HCL2-7, _***_**_BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION***_**

_***_**_END HIGHLY CONFIDENTIAL HSR INFORMATION ***_**

[34] Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, page 89.

broadband, wireless, wireline and other related communication services to mass market, business, government and wholesale customers in markets across the United States and to business customers internationally, and the transactions would allow Verizon to focus more intently on transitioning its traditional wireline customer base to broadband.

- Verizon's expectation that the Verizon Group will receive $1.7 billion comprised of the special cash payment and the Spinco securities, which it may use either to reduce the debt of members of the Verizon Group or repurchase Verizon common stock.
- The potential value, as determined by evaluating pre- and post-transaction discounted cash flows and the valuation of comparable businesses, of the approximately 60% of the combined company that Verizon stockholders will own after the spin-off and merger.
- The expected tax-efficient structure for Verizon stockholders of the proposed spin-off and immediate merger of Spinco with FairPoint.
- The benefits that might accrue to Verizon stockholders as owners of FairPoint common stock after the merger, including specifically that FairPoint intends to continue its existing dividend policy after the merger.[35]

Q. WAS THE AMOUNT OF DEBT THAT COULD BE BORNE BY THE ACQUIRER IMPORTANT TO VERIZON?

A. *****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****

<u>*END HIGHLY CONFIDENTIAL HSR INFORMATION***</u>**.[36]

[35] Id.

[36] See Exhibit DB-HCL2-8, Verizon HSR Attachment 4(c)-12, <u>*****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****</u> <u>*****END HIGHLY CONFIDENTIAL HSR INFORMATION*****</u>

Q. IS THE AMOUNT OF DEBT TO BE BORNE BY FAIRPOINT RELATED TO THE OPERATING NEEDS OF THE NORTHERN NEW ENGLAND STATES?

A. No. The $2.3 billion in FairPoint debt that is an outcome of the proposed transaction is not incurred to fund fulfillment of operating needs in the Northern New England states. Rather, it is incurred to refinance existing debt, and provide $1.7 billion for elimination of existing Verizon debt. So, much of the debt is incurred essentially in order to permit Verizon to de-leverage.

Q. ARE THE INTERESTS OF VERIZON AND FAIRPOINT IN HARMONY REGARDING THE AMOUNT OF LEVERAGE ON SPINCO?

A. No . According to FairPoint (or at least its investment advisor), *****BEGIN HIGHLY CONFIDENTIAL*****

*****END HIGHLY CONFIDENTIAL ***** [37]

FairPoint's original proposed debt leverage for Spinco was "3.25 to 3.5 times earnings before interest, taxes, depreciation and amortization, referred to as EBITDA, which would result in a leverage ratio of 3.6 to 3.7 times EBITDA for the combined company".

[37] See Exhibit DB-HCL2-9, FairPoint HSR Attachment 4(c)-3, February 20, 2006 presentation by Lehman Brothers

[38] FairPoint elsewhere stated, **<u>***BEGIN HIGHLY CONFIDENTIAL***</u>**

<u>*END HIGHLY CONFIDENTIAL***</u>** [39] Verizon obviously required more funds from the transaction, since debt leverage of the proposed transaction as announced is 4.1x.[40]

D. Reverse Morris Trust

Q. WHAT IS YOUR UNDERSTANDING OF THE REVERSE MORRIS TRUST STRUCTURE OF THIS PROPOSED TRANSACTION?

A. The "Reverse Morris Trust" (RMT) nature of this proposed transaction is perhaps the primary way to structure it in order to provide "tax-free" status for the proposed transaction. There are different ways for Verizon Communications to dispose of its operations in the northern New England states, including an outright sale of the operations. However, a straight sale of the operations would

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(FairPoint's consultant), page 6 (CFPNH HSR 0035).
[38] Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4,, at page 55.
[39] See Exhibit DB-HCL2-10, FairPoint HSR Attachment 4(c)-2, March 16, 2006 letter from FairPoint to Verizon, page 4 (CFPNH HSR 0023).

tend to trigger tax liability for Verizon Communications in the form of capital gains.

The RMT is a process recognized by the IRS as permitting a tax free spin off of operations. FairPoint's view is that "a Reverse Morris Trust provides a financially-attractive method for a corporation to divest assets or business operations in a non-taxable transaction."[41] Further, FairPoint states:

> The Reverse Morris Trust structure allows the FairPoint shares to be distributed to Verizon shareholders on a tax-free basis, and the amount of the one-time dividend received by Verizon will also be a tax-free distribution.[42]

Verizon states:

> The proposed transaction is designed to establish a separate entity as the holding company for Verizon's local exchange, long distance and related business activities in Maine, New Hampshire and Vermont, spin off the stock of that new entity to Verizon shareholders, and immediately merge it into FairPoint. The transaction is designed to ensure that the equity distribution (i.e., the spin-off) and the merger are tax-free to Verizon and its shareowners under the Internal Revenue Code.[43]
>
> The [exchange] ratio [of Spinco shares for FairPoint shares] was determined as a result of arms length negotiations as part of the valuations of Spinco and the relative value of the ownership interests each company's shareholders would hold in the combined company after the merger. <u>In order to qualify as a tax-free event under the Internal Revenue</u>

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[40] See Exhibit DB-P-3, FairPoint Communications Transaction Announcement, January 16, 2007, at page 5.
[41] Balhoff Testimony on behalf of FairPoint, page 13, line 5.
[42] See Exhibit DB-P-13, FairPoint's reply to CWA/IBEW GI 1-23, April 19, 2007, Docket No. 7270, Vermont Public Service Board.
[43] Smith Testimony on behalf of Verizon New England, page 3, line 8.

> Code and regulations, the merger must result in shareholders of Verizon owning a majority of FairPoint. Based on the relative value of Spinco and FairPoint, the parties agreed that Verizon shareholders will own approximately 60% of the surviving company post-merger. The number of new shares to be issued to Verizon shareholders to represent approximately 60% of the surviving company bears a 1:55 ratio to the number of currently outstanding shares in Verizon.[44]

Q. FOR PURPOSES OF THIS PROCEEDING, WHAT IS THE SALIENT CHARACTERISTIC OF A REVERSE MORRIS TRUST TRANSACTION?

A. The salient characteristic of a RMT transaction is that the acquiring entity must be smaller than the operations being spun off, from a valuation standpoint.

> The Reverse Morris Trust structure basically governs the transfer of assets and who maintains a controlling ownership. In order for the transfer of assets to not generate a tax liability as determined by the IRS and the U.S. tax code, greater than 50% of the new entity must be controlled by the company distributing the assets.[45]

The direct implication of this is that only smaller entities are "on the list" for a transaction like the proposed transaction before the Commission, under a RMT structure. Larger operators do not "qualify" for a transaction the size of that proposed in this matter.

> If the market cap of a company is greater than the equity value of the deal then the company would be too large and would thus have to pass on the deal. We believe an example of this was the FairPoint transaction, which would have been too small for CenturyTel, Citizens, or Windstream (itself under certain Reverse Morris Trust limitations) so it went to FairPoint.

[44] Smith Testimony on behalf of Verizon New England, page 16, line 20, emphasis added.
[45] Exhibit DB-P-14, "VZ: Analyzing Future Line Sales Under Reverse Morris Trust Scenarios", Telecommunications Services Wireline Industry Brief, Equity Research, Raymond James & Associates, Inc., January 30, 2007, at page 3.

> We believe the potential partners of Verizon North [for future access line sales] would be Alaska, Consolidated Telecom, Cincinnati Bell, or Iowa Telecom.[46]

Q. WAS A REVERSE MORRIS TRUST ESSENTIALLY A REQUIREMENT FOR THE PROPOSED TRANSACTION?

A. *****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****

[47]

*****END HIGHLY CONFIDENTIAL HSR INFORMATION*****For example, according to the February 20, 2006 Lehman Brothers presentation, *****BEGIN HIGHLY CONFIDENTIAL*****

[46] Id, at page 4.

[47] See Exhibit DB-HCL2-8, Verizon HSR Attachment 4(c)-12, *****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION***** *****END**

<u>*END HIGHLY CONFIDENTIAL***</u>**.[48]

<u>*BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION***</u>**

<u>*END HIGHLY CONFIDENTIAL HSR INFORMATION***</u>**. Further details regarding RMT and its impact are not known to the OCA or the Commission since Verizon objected to providing such information.[49]

<u>HIGHLY CONFIDENTIAL HSR INFORMATION*</u>**

[48] See Exhibit DB-HCL2-9, FairPoint HSR Attachment 4(c)-3, February 20, 2006 presentation by Lehman Brothers (FairPoint's consultant), page 6 (CFPNH HSR 0035).

[49] See Exhibit DB-P-15, Verizon's supplemental reply to OCA GI 1-113.

III. Implications and Adequacy of Process

Q. WHAT WAS THE PROCESS THAT VERIZON USED LEADING TO THE PROPOSED TRANSACTION IN THIS MATTER?

A. Verizon's testimony outlines the process:

> Verizon regularly receives expressions of interest from third parties interested in acquiring its access line properties. When those expressions are credible, Verizon investigates and evaluates the proposals to satisfy its fiduciary responsibility to shareowners. The potential transfer of Maine, New Hampshire and Vermont first arose from this kind of activity.[50]
>
> … [Mr. Smith directed] preparation of descriptive information about [Verizon's] businesses in Maine, New Hampshire and Vermont, distributed that information to FairPoint and other interested parties and negotiated preliminary indications of interest.[51]

The **<u>***BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION***</u>** **<u>***END HIGHLY CONFIDENTIAL HSR INFORMATION***</u>**.[52] Further, "Verizon said in May [2006] it was putting lines in New Hampshire, Vermont and Maine on the block as well as lines in several Midwestern states."[53]

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[50] Smith Testimony on behalf of Verizon New England, page 2, line 15.

[51] Smith Testimony on behalf of Verizon New England, page 1, line 21.

[52] See Exhibit DB-HCL2-3, Verizon HSR Attachment 4(c)-13, <u>*****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****</u> <u>*****END HIGHLY CONFIDENTIAL HSR INFORMATION*****</u>

[53] Exhibit DB-P-9, "Verizon Considers FairPoint Bid for Land Lines in New England", <u>The Wall Street Journal</u>, August 19, 2006.

*****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****

*****END HIGHLY CONFIDENTIAL HSR INFORMATION*****.[54] At that time, *****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****

*****END HIGHLY CONFIDENTIAL HSR INFORMATION*****.[55]

[54] See Exhibit DB-HCL2-4, Verizon's HSR Attachment 4(c)-10, *****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****
*****END HIGHLY CONFIDENTIAL HSR INFORMATION*****

[55] See Exhibit DB-HCL2-4, Verizon's HSR Attachment 4(c)-10, *****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****
*****END HIGHLY CONFIDENTIAL HSR INFORMATION*****

The process was later summarized for the Verizon Board of Directors as follows:

*****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****

*****END HIGHLY CONFIDENTIAL HSR INFORMATION*****.[56]

Q. TO WHAT EXTENT WERE OTHER MID-SIZED TELCOS INVOLVED IN THE PROCESS?

A. In summer 2006, Verizon received two more indications of interest. "Verizon was also fielding offers from CenturyTel Inc., of Monroe, La., and Citizens Communications Co., of Stamford, Conn., according to union officials."[57]

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[56] See Exhibit DB-HCL2-6, Verizon HSR Attachment 4(c)-3, *****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION***** *****END HIGHLY CONFIDENTIAL HSR INFORMATION*****

[57] Exhibit DB-P-9, "Verizon Considers FairPoint Bid for Land Lines in New England", The Wall Street Journal, August 19, 2006.

As noted above, these two entities are too large for the transaction to have qualified as a RMT, **<u>***BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION***</u>**

<u>*END HIGHLY CONFIDENTIAL HSR INFORMATION***</u>**.

Q. HAS THIS PROPOSED TRANSACTION BEEN LIKENED TO THE PREVIOUS TRANSACTIONS THAT CREATED EMBARQ AND WINDSTREAM?

A. Verizon and FairPoint have from time to time likened this proposed transaction to the Sprint/Nextel spin off of its local telecommunications division (that created Embarq) and the Alltel spin off of its local telecommunications division and subsequent merger into Valor Communications (which created Windstream).

Q. DO YOU VIEW THE EMBARQ AND WINDSTREAM TRANSACTIONS AS HAVING A CLOSE RESEMBLENCE TO THIS PROPOSED TRANSACTION, SUFFICIENT TO BE VIEWED AS "PRECEDENTIAL"?

A. No. The only significant similarity is that both were structured to be tax-free transactions. Embarq was structured as a tax-free spin off to existing shareholders, and

Windstream was structured as a tax-free Reverse Morris Trust transaction, using Valor Communications as the merger partner. Beyond that, there are significant differences between the Embarq and Windstream transactions, and this proposed transaction such that in my view the differences are much more important than any superficial similarities.

I summarize the significant differences as follows:

1. The Embarq and Windstream transactions were essentially internal in nature, and pertained to entire existing corporate divisions. Sprint/Nextel spun off an internal division—the Local Telecommunications Division, and Alltel also spun off its local telecommunications division and related entities. In this case, Verizon is essentially "selling" a three-state portion of its operations to an outside entity.

2. Perhaps as a consequence, neither Embarq nor Windstream was spun off with leverage as high as the 4.1x leverage proposed for FairPoint. While the debt assumed by Embarq and Windstream was very substantial, in relative terms those debt levels were substantially lower than proposed here. An objective of the Embarq spin off was to enable investment grade bond ratings. Embarq's net debt to EBITDA was 2.5x at end of year 2006 and 2.3x at the end of first quarter 2007 due to long term debt repayment of $363m.[58] This is a <u>material</u> debt repayment that occurred in Embarq's first year of

[58] Embarq Investment Community Update, First Quarter 2007, dated April 25, 2007

existence, and was substantially enabled due to its significantly lower debt levels—i.e., it was not required to service debt at over 4 times EBITDA. Windstream also has substantially lower debt leverage—it calculates a net debt to "OIBDA" at 3.1x.[59]

3. Again as a product of the fact that the transactions were a spin off of existing divisions, neither Embarq nor Windstream had significant issues regarding integration of non-union employees into the new company's workforce. Embarq and Windstream assumed an existing employee base. FairPoint *****BEGIN HIGHLY CONFIDENTIAL*****,

*****END HIGHLY CONFIDENTIAL***** [60] FairPoint recognized *****BEGIN HIGHLY CONFIDENTIAL*****

*****END HIGHLY CONFIDENTIAL*****.[61]

4. Again as a product of the fact that the transactions were a spin off of existing divisions, Embarq and Windstream were spun off with an essentially intact full management team. Consequently, there was no requirement for Embarq or

http://investors.embarq.com/phoenix.zhtml?c=197829&p=irol-newsArticleFinancial&ID=990514&highlight=

59 Windstar CEO Letter to Shareholders, 2006 Annual Report to Shareholders, March 30, 2007 http://thomson.mobular.net/thomson/7/2264/2488/

60 See Exhibits DB-HCL2-2, FairPoint HSR Attachment 4(c)-9, CEO Conference July 25, 2006 "Highly Confidential" – FairPoint personnel only, at page 3 (CFPNH HSR 0214).

61 See Exhibit DB-HCL2-11, FairPoint HSR Attachment 4(c)-11, March 1, 2006 e-mail from Peter Nixon to Walter Leach**,**

Windstream to develop, integrate and implement operating and management systems "from scratch". The nature and duration of the transitions for Embarq and Windstream would therefore be significantly different from that necessary for this proposed transaction.

For these reasons, I consider the proposed transaction to be considerably different from, and more risky than the Embarq or Windstream spin-offs. Of particular note is the increased execution risk, given that FairPoint must assemble and integrate a large new management and employee team, and develop, integrate and implement operational and management systems "from scratch"—which neither Embarq nor Windstream had to do. This is also in stark contrast to the nature of all previous FairPoint acquisitions.

"The value maximizing equation for Verizon is to structure the deal as a Reverse Morris Trust then sell the spin-co to an existing company, <u>with extant management, back office and other required infrastructure</u> to run the combined company <u>so that value is not destroyed in creating such corporate infrastructure</u>".[62] Unfortunately, in the case of the proposed transaction (and completely unlike Embarq and Windstream), the existing company—FairPoint—does not have the "extant management, back office and other

at page 1 (CFPNH HSR 0228).

[62] Exhibit DB-P-14, "VZ: Analyzing Future Line Sales Under Reverse Morris Trust Scenarios", Telecommunications Services Wireline Industry Brief, Equity Research, Raymond James & Associates, Inc., January 30, 2007, at page 1, <u>emphasis added</u>.

required infrastructure". This greatly enhances execution risks compared to the Embarq and Windstream transactions as referenced by FairPoint and Verizon.

Q. WHAT IS YOUR OPINION OF THE PROCESS THAT VERIZON USED TO SELECT AN ENTITY TO AQUIRE ITS ILEC OPERATIONS IN NEW HAMPSHIRE, MAINE AND VERMONT?

A. **<u>***BEGIN CONFIDENTIAL INFORMATION***</u>**

*****<u>END CONFIDENTIAL***</u>**.

IV. High Debt/High Dividend Rural LECs

Q. WHAT IS A "HIGH DEBT/HIGH DIVIDEND RURAL LEC"?

A. I view a "high debt/high dividend" rural LEC as one which has both high debt leverage, and high yield dividend policy. This is a relatively small group of publicly traded companies, arguably consisting of FairPoint, Alaska Communications Systems, Citizens' Communications, Consolidated Communications, Iowa Telecom, and Windstream. Cincinnati Bell is excluded since it pays no dividends (and isn't particularly rural), although it does have high debt leverage. I also exclude Embarq from this category since its dividend yield and payout ratio is much lower than the others, and since its debt leverage is also much lower and it has made immediate and significant reduction to its debt leverage.

FairPoint's July 2, 2007 amendment to its S-4 ("July 2 S-4A") shows the following "Comparable Company Analysis", from the Lehman Brothers presentation materials[63]:

[63] See DB-P-2, FairPoint Amendment No. 4, at p. C-1-13.

	Current Dividend Yield	Dividend Payout Ratio	Total Debt/LTM EBITDA
Alaska Communications	5.6%	75.0%	3.7x
Citizens	7.1%	65.0%	3.4x
Consolidated Communications	7.6%	70.0%	4.4x
Iowa Telecom	8.5%	78.0%	3.9x
Windstream	7.2%	81.0%	3.3x
Embarq	3.8%	39.0%	2.4x
FairPoint	8.4%	91.0%	4.9x

The figures for Citizens' Communications are stand-alone, and do not include its pending acquisition of Commonwealth Telephone.

A "high debt/high dividend" rural LEC is at the upper end of the risk spectrum for both equity and debt components of the capital structure. Higher debt leverage increases the risk that fixed payments of principal and interest cannot be paid, all other things equal. Higher dividend yield increases the risk that indicated dividend levels cannot be paid, all other things equal. Furthermore, problems at one company could affect the group as a whole. "If one company stumbles, all could fall. … We believe that if one of these high payout RLECs began to have trouble generating enough cash to pay its dividend, even on a temporary basis, the market could move in the direction of these apples-to-apples dividend discount model values."[64]

> We do believe that reductions in the dividends will happen eventually given the declining nature of these businesses. As the businesses near the point when eventual dividend cuts happen, we believe the stocks will trade on a net present value of the remaining cash flows of the business less net debt.[65]

Clearly there would be a substantial decline in the valuation of a firm at that point with substantial debt levels. **<u>***BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION***</u>**

<u>*END HIGHLY CONFIDENTIAL HSR INFORMATION***</u>**. [66]

Q. HOW ARE "COMPARABLE COMPANIES" USED IN VALUATION ANALYSES?

A. As shown above, "comparable companies" are used for key metrics to obtain comparative ranges, including means and medians. These comparative statistics are used to benchmark the proposal being evaluated, to determine the extent to which it is in the

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[64] Exhibit DB-P-16, Morgan Stanley Research, "Telecom Services Initiation of Coverage: High Payout Rural Telecoms Offer Near Term Opportunities, Long Term Risks", April 17, 2006, at page 13.

[65] Id., at page 14.

[66] See Exhibit DB-HCL2-5, Verizon HSR Attachment 4(c)-8, **<u>***BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION***</u>** **<u>***END HIGHLY</u>**

comparative range, or not. As might be imagined, the crucial determination is which companies are comparable. The need for data also implies that the comparable companies must be public, so that financial and operating data for comparative purposes is available.

Q. WHAT COMPANIES WERE USED BY VERIZON IN ITS ANALYSES AS "COMPARABLE" COMPANIES?

A. Verizon *****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****

*****END HIGHLY CONFIDENTIAL HSR INFORMATION*****. [67]

Q. WHAT IS THE INDICATED DEBT LEVEL FOR FAIRPOINT FOLLOWING THE PROPOSED TRANSACTION?

A. FairPoint's debt level is indicated to be approximately $2.5 billion, following closing of the proposed transaction. Its net debt leverage is projected to be 5.1x in 2008, and 4.5x EBITDA in 2009.[68]

CONFIDENTIAL HSR INFORMATION***

[67] [67] See Exhibit DB-HCL2-7, Verizon HSR Attachment 4(c)-4, *****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****

*****END HIGHLY CONFIDENTIAL HSR INFORMATION*****

[68] See Exhibit DB-P-8, FairPoint Amendment No. 5 to S-4 , at pages 76 ("pro forma combined EBITDA") and 78 ("Long Term Debt") minus cash of $3 million.

Q. HAS FAIRPOINT CONSISTENTLY USED HIGH DEBT LEVERAGE?

A. Yes. FairPoint has historically used very substantial debt levels, along with minimal book equity. This has caused high interest expenses and other substantial charges associated with refinancing or early retirement of debt. FairPoint describes itself as an "acquisition company", but along with this has come high levels of debt and periodic efforts at refinancing of the company.

Q. WHAT DOES FAIRPOINT'S FINANCIAL MODEL INDICATE RELATED TO A PLAN OR PROJECTION TO REDUCE DEBT LEVERAGE?

A. FairPoint's financial model **<u>***BEGIN HIGHLY CONFIDENTIAL***</u>**

<u>*END HIGHLY CONFIDENTIAL***</u>**.

FairPoint does not intend to adhere to this model assumption,[69] however, so actually the leverage ratio will grow, all other things equal. Similarly, this model assumption reduces

[69] Direct Testimony of Walter Leach on behalf of FairPoint, at page 33.

interest expense from what it would otherwise be since FairPoint does not actually intend to pay off debt consistent with the model assumption**.**

Q. IS LEVERAGE BENEFICIAL?

A. Leverage is a "two-edged sword", in that when times are good, leverage can be beneficial financially, but when times are bad due to economic conditions, unexpected revenue or operating losses, or greater than expected need for cash, leverage becomes a problem. Leverage magnifies financial problems since high fixed costs (debt interest and principal payments) are associated with leverage.

Q. AS A HIGH DEBT/HIGH DIVIDEND ILEC, HOW WOULD FAIRPOINT'S COST OF CAPITAL COMPARE TO VERIZON'S COST OF CAPITAL?

A. In general, I believe FairPoint would expect its cost of capital would be higher due to higher relative risks to FairPoint debt and equity as compared to Verizon, at the time when that becomes an issue, such as when increased rates become necessary. FairPoint's high debt leverage causes it to have "junk bond" credit ratings, for which investors demand a higher return as compared to "investment grade" credit ratings, which Verizon has. Therefore, it can be expected that FairPoint would seek a higher cost of debt than that which pertains to Verizon. I also expect that FairPoint would seek the same or higher cost of equity than that sought by Verizon.

Variation in the allowed rate of return drives substantial earnings dollars, so the more dollars that FairPoint could obtain through a higher rate of return in a particular jurisdiction, the more dollars that can be "dividended up" to the parent holding company for payment of debt interest, dividends and other corporate uses of cash (all other things equal). New Hampshire's regulatory policy is based on rate of return calculations, so FairPoint will have the incentive if the transaction is approved to seek higher rates of returns through rate filings.

Q. DOES FAIRPOINT'S $142 MILLION IN ANNUAL DIVIDEND EXPENDITURE PROVIDE A "BUFFER" IF THE COMPANY'S PROJECTIONS REGARDING FREE CASH FLOW ARE NOT ACHIEVED?

A. FairPoint states in a filing before the FCC that "dividends are discretionary—FairPoint can choose not to pay them under its current dividend policy."[70] FairPoint makes the same point in various responses in this case.[71] Also, the Leach rebuttal testimony in Vermont states that:

> If the short-term choice must be made between what is right for the long-term heath of the business and paying discretionary, near-term dividends, management would recommend that our board of directors choose to invest in operations and maintain quality service to customers, and we expect that the board would decide to do so. We would not, as Mr. Barber suggests, prioritize actions that could potentially sour the company's relationships with critical constituencies (such as requesting large rate

[70] See Exhibit DB-P-11, Verizon's and FairPoint's "Opposition to Petitions to Deny", WC Docket No. 07-22, before the Federal Communications Commission, May 7, 2007, Leach Affidavit, at page 4 (FPNH 0826).
[71] See, e.g., Exhibit DB-P-17, FairPoint reply and first supplemental reply to Staff GI 1-89.

> increases from our customers, dramatically reducing employment, or ceasing to invest in our network).[72]

Unfortunately, given FairPoint's weak financial position, there will be no good choices at that time: interest and debt payments are mandatory; stockholders expect their dividends; capital investments are required from an operational standpoint for quality of service and to meet DSL commitments, and taxes and operating expenses must be paid. Realistically, reducing dividends would probably be no easier than any of the other bad options, when those choices are necessary.

Q. IS THERE A RATIONALE FOR STABLE DIVIDEND LEVELS OVER TIME?

A. Yes. There is reason to expect that a stable dividend policy will lead to higher stock prices. Investors can be expected to value more highly dividends that are relatively certain versus dividends which are believed to be variable or subject to being cut. Shareholders who depend on dividends for income can also be expected to value stable dividend paying shares versus dividends that are believed to be variable. "In view of investors' observed preference for stable dividends and of the probability that a cut in dividends is likely to be interpreted as forecasting a decline in earnings, stable dividends make good sense."[73]

[72] Rebuttal Testimony of Walter Leach, Docket No. 7270,Vermont Public Service Board, filed June 27, 2007, at page 57.
[73] Managerial Finance, Weston and Brigham, Sixth Edition, 1978, at page 809.

Reduced dividends suggest a reduced stock price. Therefore, I do not view it as realistic for the Commission to expect FairPoint to not to pay dividends, from time to time based on a problematic cash flow shortfall. Any dividend reduction would have to be long term, with later increases based on improvements in the company's profits and cash flows.

FairPoint should proactively reduce its dividend in concert with this transaction to provide more cash to be used for debt repayment, DSL buildout, and other capital expenditures. The current dividend level was established when FairPoint was a different company than it would be under the proposed transaction. FairPoint's net cash flows post transaction as projected are not certain enough to support continuation of the dividend at the current level . This is viewed as a "transforming" transaction for FairPoint, and there is no reason in light of the facts not to also transform the dividend policy.

Q. TURNING TO THE LONG TERM DEBT, PLEASE DESCRIBE THE LONG TERM DEBT WHICH FAIRPOINT INTENDS TO UTILIZE FOR THIS TRANSACTION.

A. Documents included with FairPoint's application in this matter, and SEC Form S-4A filings by FairPoint indicate it has secured a bank commitments for $2.08 billion in long term debt, composed of $200 million in a six year revolving credit facility, $1.68 billion in a "Term loan B" facility and a $200 million delayed draw term loan facility which is available to be drawn until the first anniversary of the merger closing date. Both of the latter loans mature in eight years.

FairPoint will "pay certain fees and expenses in connection with the new credit facility", such as commitment and other fees.[74] It is assumed that FairPoint will borrow $900 million through this new senior secured credit agreement (or otherwise obtain the funds) in order to pay Verizon the "special dividend" for the tax basis of the properties and operations acquired.[75] In addition, much closer to the closing date and outside the bank commitment letter, FairPoint intends to issue approximately $800 million in senior unsecured notes that Verizon will be able to take and "swap" for its own debt. The special dividend payment and the debt swap permit Verizon to reduce its overall debt by $1.7 billion.

It is also assumed that FairPoint will use proceeds from the new credit facility in the amount of $643 million to pay off existing debt obligations, accrued interest and $25 million in debt issuance costs.[76] The pro forma estimated long term debt of FairPoint immediately following the merger is depicted in the following table:

[74] Exhibit DB-P-8, FairPoint Amendment No. 5 to S-4, at page 135.
[75] Exhibit DB-P-8, FairPoint Amendment No. 5 to S-4, at page 211.
[76] Exhibit DB-P-8, FairPoint Amendment No. 5 to S-4, at page 211.

Senior secured term loan B--8 year maturity, variable rate	$1,543
Spinco securities, fixed rate	$800
($millions)	$2,343

FairPoint's July 2 S-4A, however, shows 2008 Long Term Debt in the amount of $2,516 million.[77] There is some variation in the debt that FairPoint expects to assume under the proposed transaction structure.

Q. IS FAIRPOINT SIGNIFICANTLY EXPOSED TO INTEREST RATE RISK?

A. Yes. The proposed new bank debt for the holding company is to be carried at a variable interest rate. The bank debt bears interest at a variable rate based on a chosen short term interest period (1, 2, 3, or 6 months as selected by the borrower, or 9 or 12 months if agreed to by the lender) based on Adjusted LIBOR (London Interbank Rate) plus an additive margin, or an interest rate that appears to be fixed based on a "prime rate" plus an additive margin.[78] The risk in this context is that interest rates will continue to rise, thus causing FairPoint to bear increased fixed charges associated with higher interest for the debt which is carried at the variable rate. These higher interest expenses must be paid, and would preempt cash use that had been planned or is necessary for other purposes (e.g., dividends or capital investment or operating expenses).

[77] See Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at page 78.

Regarding the "Spinco securities" ($800 million), FairPoint notes that "some of the terms described [in the S-4A] may change depending on market conditions."[79] As an indication of the time-dependent nature of interest rates, *****BEGIN HIGHLY CONFIDENTIAL***** *****END HIGHLY CONFIDENTIAL***** while the current federal funds rate as of July 12, 2007 is *****BEGIN HIGHLY CONFIDENTIAL***** *****END HIGHLY CONFIDENTIAL***** 5.25%.

Q. IS FAIRPOINT'S STOCK PRICE ALSO EXPOSED TO ADDITIONAL RISK FROM HIGHER INTEREST RATES?

A. Yes. FairPoint's stock is a "yield based" investment due to the high payout dividend level. As a yield based investment, the stock price will therefore be affected negatively by rising interest rates—the stock price will tend to decline with increasing interest rates.

Q. HAS FAIRPOINT EMPLOYED INTEREST RATE HEDGING PRACTICES?

A. Yes. FairPoint has used and currently uses interest rate swap agreements. The interest rate swap agreements in place apply only to FairPoint's existing debt which is expected to be repaid with proceeds from the new credit agreement. On the new debt, "the interest on a portion of the senior secured term loan B is expected to be fixed through the use of

[78] See Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at page 135.
[79] Id., at page 211.

interest rate swap agreements. The total fixed portion was assumed to be $550 million at a blended rate of 6.3%."[80]

Q. ARE THESE HEDGING PRACTICES SUFFICIENT TO AVOID INTEREST RATE RISK?

A. No. Interest rate risk cannot be eliminated; it can only be transferred or otherwise mitigated at a cost. Further, as FairPoint has noted:

> After these interest rate swap agreements expire, our annual debt service obligations with respect to borrowings under our credit facility will vary from year to year unless we enter into a new interest rate swap or purchase an interest rate cap or other interest rate hedge. If we choose to enter into a new interest rate swap or purchase an interest rate cap or other interest rate hedge in the future, the amount of cash available to pay dividends on our common stock may decrease. However, <u>to the extent interest rates increase in the future, we may not be able to enter into a new interest rate swap or purchase an interest rate cap or other interest rate hedge on acceptable terms</u>.[81]

FairPoint can seek to use interest rate hedges, but these cannot eliminate the interest rate risk that would exist for FairPoint given its heavy debt leverage, and use of variable interest rates for large portions of that debt. Even with interest rate hedge instruments, FairPoint remains exposed to trends of increasing interest rates, particularly since its financial projections show that it will continue to have significant long term debt, and will have to refinance most if not all of that debt, **<u>***BEGIN HIGHLY</u>**

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[80] Exhibit DB-P-8, FairPoint Amendment No. 5 to S-4, at page 211.

[81] Exhibit DB-P-18, FairPoint Form 10-K, March 14, 2006, page 18, <u>emphasis added</u>.

CONFIDENTIAL* ***END HIGHLY CONFIDENTIAL***at or before maturity.

An illustration of the fact that hedging instruments do not entirely avoid risks or provide "permanent" protection can be found from the example of Southwest Airlines. Southwest Airlines "utilized financial hedging instruments to lock in low fuel prices", but "as its hedges become less effective, Southwest is facing big jumps in fuel costs".[82]

Q. IS THE APPLICABLE MARGIN OVER LIBOR FIXED AT THIS POINT?

A. No. The applicable margin over LIBOR used to calculate the interest rate on FairPoint's revolving loan under the new credit facility is not yet fixed.[83]

> Under the new credit facility, FairPoint and Spinco expect to make borrowings at Adjusted LIBOR …. Plus a margin which in the case of the revolving credit facility will be subject to a leverage based pricing grid to be agreed by the parties. … <u>The applicable margins under the new credit facility have not yet been negotiated</u>. [84]

This is a further significant interest rate exposure such that changing market conditions may lead lenders to require payment of higher margins than have recently prevailed, and higher margins than are currently used in FairPoint's financial model projections. Also, since some of the margins are fixed in the January 2007 commitment letter, a year after that date or later, banks may not be able to sell the offering to investors at that margin, if

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[82] Exhibit DB-P-19, "As Competition Rebounds, Southwest Faces Squeeze: Growth Hits Turbulence for Low-Cost Pioneer; Fuel Hedges Lose Lift", <u>The Wall Street Journal</u>, June 27, 2007.
[83] See Exhibit DB-P-8, FairPoint Amendment No. 5 to S-4, at page 135.
[84] Exhibit DB-P-8, FairPoint Amendment No. 5 to S-4, at page 135, <u>emphasis added</u>.

margins have increased from January 2007 levels under current market conditions at that future time in 2008.

Q. ARE INTEREST RATE MARGINS OVER LIBOR TO COMPENSATE FOR RISK FIXED AT SOME UNCHANGING LEVEL OVER TIME?

A. **<u>***BEGIN HIGHLY CONFIDENTIAL***</u>**

<u>*END HIGHLY CONFIDENTIAL***</u>** the LIBOR base rate, which is a "risk free" rate similar to U.S. Treasury obligations. This margin is at a historic level, will not realistically remain at that level, and in fact there is every reason to believe the margins will be increasing, as supported by the following press reports:

- "The flood of new debt in the high-yield bond market hasn't widened risk premiums. Within the past week, the Lehman Brothers U.S. High yield index showed risk premiums hit a record low of 232 basis points over Treasurys." "The premium investors charge companies to compensate them for default risk has shrunk to reach near or record lows in May, even though the new debt raised is being used to finance activities that typically bode poorly for bondholders: stock buybacks and leveraged buyouts."[85]

- "In recent months, lower credit bonds—conventionally defined as BB+ and below—have traded at a smaller risk premium (as compared to U.S. Treasuries) than ever before in history. Over the past 20 years, this margin averaged 5.42 percentage points. Shortly before the Asian crisis in 1998, the spread was hovering just above 3 percentage points. Earlier this month, it touched down at a record 2.63 percentage points. That's less than 8% money for high-risk borrowers."[86]

- "Several factors underlie the new pushback against buyout financings. One is the growing awareness that investors have been demanding

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[85] Exhibit DB-P-20, "Demand Continues for Debt; Investors Rush in to Take on Risk", <u>The Wall Street Journal</u>, June 1, 2007.

[86] Exhibit DB-P-21, "The Coming Credit Meltdown", <u>The Wall Street Journal</u>, June 18, 2007.

> very little in return for the risk they have accumulated in buying buyout-related loans and debt. Yields on junk bonds, when compared with ultrasafe U.S. Treasury securities, hit historic lows around a month ago. … In addition to demanding higher interest rates, investors are resisting many bonds and loans that they believe to be too easy on borrowers. Investors have rejected a number of recent deals that included "payment-in-kind" provisions, which allow companies to postpone debt payments to their lenders if they run short of cash. Investors also have rejected loans that are light on common performance requirements, known as covenants. … Banks in several cases have been stuck holding portions of loans or bonds they planned to parcel out to investors, something that could make them more selective in underwriting deals."[87]

- "Financial advisors say this marks a good time for investors to re-evaluate their high-yield holdings. Currently the average high-yield bond is giving a yield of only about three percentage points more than U.S. Treasury bonds, which are among the safest investments available. For comparison, as recently as 2002, that gap was around nine to 10 percentage points."[88]

- "While the spread between junk bonds and a 10-year Treasury note—which shows how much lenders charge for added risk—has increased by almost a percentage point since the end of May to 3.43 percentage points, its still well below the long-term spread of 5 percentage points."[89]

The fact that margins for high yield securities are at historic lows has great significance for this proposed transaction. FairPoint's projections show *****BEGIN HIGHLY CONFIDENTIAL*****

[87] Exhibit DB-P-22, "Market's Jitters Stir Some Fears for Buyout Boom: Takeover-related Debt Gets Chilly Reception; Hearing 'Wake up' Call", The Wall Street Journal, June 28, 2007.
[88] Exhibit DB-P-23, "The Junkyard Dogs Investors in Some Funds: Rising Risk Premiums Hit High Yield Holdings; 'I wouldn't be an Owner'", USA Today, July 10, 2007, P-23.
[89] Exhibit DB-P-24, "Corporations have Trouble Borrowing", USA Today, July 24, 2007, page 4B.,

<u>*END HIGHLY CONFIDENTIAL***</u>**.

Furthermore, and very importantly, the interest cost for the proposed "SpinCo" bonds is not yet set, and will be determined by market conditions much closer to closing of the proposed transactions.[90] In light of the above, FairPoint is subject to much higher interest cost than that which is included in the model projections.

Due to its weak financial position, FairPoint cannot weather these increased interest costs by making other changes. Cash is necessary for dividends, capital expenditures, cash expenses and taxes. FairPoint's exposure to increased interest expenses creates the substantial likelihood of a distressed public utility if the Commission approves the proposed transaction.

Q. WHAT BENEFIT HAS FAIRPOINT HISTORICALLY DERIVED FROM NET OPERATING LOSS CARRYFORWARDS?

A. FairPoint has historically derived substantial benefits from Net Operating Loss (NOL) carryforwards, which are application of previous years' net operating losses to reduce current year's tax liabilities. FairPoint has paid little to no cash taxes in previous years due to NOL carryforwards. The fact that cash is not paid for taxes enhances cash availability for dividends and interest payments. This has been one contributor to FairPoint's ability to make interest and dividend payments as a "high debt/high dividend" ILEC.

Q. WILL THESE NET OPERATING LOSS CARRYFORWARD'S CONTINUE INDEFINITELY?

A. No. Consummation of the proposed transaction will accelerate the absorption of the NOL carryforwards, such that FairPoint is projected to pay cash taxes beginning in 2009.[91]

Q. DOES FAIRPOINT UTILIZE AN EXTENSIVE ARRAY OF AFFILIATES AND SUBSIDIARIES?

A. Yes. These affiliates and subsidiaries are identified on Exhibit 21 to FairPoint's Form 10-K SEC filing, among other places. Referring to FairPoint's largest New England presence, it shows for example that several of the FairPoint Maine companies are

[90] See Exhibit DB-P-8, FairPoint Amendment No. 5 to S-4, at pages 110 and 137.

subsidiaries of Utilities Incorporated, which is a subsidiary of MJD Ventures, Inc., which is a subsidiary of FairPoint Communications. Northland Telephone is a subsidiary of ST Enterprises, Ltd, which is a subsidiary of FairPoint Communications.

Q. DOES EACH LOCAL OPERATING COMPANY PROVIDE ITS OWN OPERATING FUNCTIONS?

A. No. Some functions are provided by other FairPoint affiliates at a cost. Currently the cost is addressed generically under various management services agreements between the affiliates. However, FairPoint has not yet determined the management fee structure to be applied to the acquired properties. Thus, the Commission does not know the management fees that would be charged to the three state operation from other FairPoint affiliates.

Q. ARE CURRENT FAIRPOINT COMPANIES EXPOSED TO INCREASED COSTS FROM THE PROPOSED TRANSACTION?

A. Yes. Cost allocations and charges to the operating companies via the various management service agreements are not transparent to the Commission. To the extent FairPoint incurs additional costs from the proposed transactions, there is nothing to prevent some of those increased costs from being absorbed by existing FairPoint companies. The intertwining of affiliates obscures source cost information from the Commission's view.

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[91] See Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4A, at page 77.

<u>V. High Level of Risk Factors Increase the Likelihood of a Distressed Public Utility</u>

Q. WHAT RISKS DOES FAIRPOINT IDENTIFY?

A. In its proxy statement/prospectus, as it relates to the issuance of additional shares of stock to Verizon stockholders to accomplish the transaction, FairPoint identifies a number of risks pertaining to its business and the spin-off and merger.[92] Concerning these numerous risks, FairPoint's letter to shareholders at the beginning:

> The accompanying proxy statement/prospectus explains the merger, the merger agreement and the transactions contemplated thereby and provides specific information concerning the annual meeting. **Please review this document carefully. You should carefully consider the matters discussed under the heading "Risk Factors" beginning on page 25 of the accompanying proxy statement/prospectus before voting.**[93]

A. Risks Relating to the Spin-off and Merger

Q. PLEASE OUTLINE THE "RISKS RELATING TO THE SPIN-OFF AND MERGER".

A. The "Risk Factors" section of FairPoint's July 2 S-4A is quite extensive, and I recommend that the Commission review it in its entirety.[94] Below, I excise and discuss the issues that I view as most important for this case. The "Risk Factors" are divided into several categories, as follows:

- "Risks Relating to the Spin-off and Merger"

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[92] See Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, "Risk Factors" section, at pages 25-32.
[93] Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, Letter to Stockholders of FairPoint Communications, Inc. from Eugene B. Johnson, at page 2 (unnumbered) (emphasis in original).
[94] See Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at pages 25-32.

- “Risks Related to the Combined Company’s Business Following the Merger”
- “Risks Related to the Combined Company’s Regulatory Environment”
- “Risks Related to Investing in or Holding the Combined Company’s Common Stock”

Merger/Spin-off risks are outlined as follows:

1. “The calculation of the merger consideration will not be adjusted in the event the value of the business or assets of Spinco declines before the merger is completed. As a result, at the time FairPoint stockholders vote on the merger, they will not know what the value of FairPoint common stock will be following completion of the merger.”

2. “The integration of FairPoint's and Spinco's businesses may not be successful.”

3. “The integration of FairPoint's and Spinco's businesses may present significant systems integration risks, including risks associated with the ability to integrate Spinco's customer sales, service and support operations into FairPoint's customer care, service delivery and network monitoring and maintenance platforms.”

4. “The combined company may not realize the anticipated synergies, cost savings and growth opportunities from the merger.”

5. “After the close of the transaction, sales of FairPoint common stock may negatively affect its market price.”

6. “If the assets transferred to Spinco by Verizon are insufficient to operate the combined company's business, it could adversely affect the combined company's business, financial condition and results of operations.”

7. “The combined company's business, financial condition and results of operations may be adversely affected following the merger if it is not able to replace certain contracts which will not be assigned to Spinco.”

8. “FairPoint's or the combined company's spending in excess of the budgeted amounts on infrastructure and network systems integration and planning related to the merger could adversely affect FairPoint's or the combined company's business, financial

condition and results of operations."

9. "Regulatory agencies may delay approval of the spin-off and the merger, or approve them in a manner that may diminish the anticipated benefits of the merger."

10. "The merger agreement contains provisions that may discourage other companies from trying to acquire FairPoint."

11. "Failure to complete the merger could adversely impact the market price of FairPoint's common stock as well as FairPoint's business, financial condition and results of operations."

12. "If the spin-off does not constitute a tax-free spin-off under section 355 of the Internal Revenue Code, or the merger does not constitute a tax-free reorganization under section 368(a) of the Internal Revenue Code, including as a result of actions taken in connection with the spin-off or the merger or as a result of subsequent acquisitions of stock of Verizon or stock of FairPoint, then Verizon, FairPoint or Verizon stockholders may be responsible for payment of substantial United States federal income taxes."

13. "The combined company may be affected by significant restrictions following the merger with respect to certain actions that could jeopardize the tax-free status of the spin-off or the merger."

14. "Investors holding shares of FairPoint's common stock immediately prior to the merger will, in the aggregate, have a significantly reduced ownership and voting interest after the merger and will exercise less influence over management."[95]

I will particularly focus on risks 2-8, above.

Q. PLEASE ADDRESS THE RISKS THAT THE INTEGRATION OF THE BUSINESSES AND THE SYSTEMS OF FAIRPOINT AND "SPINCO".

A. FairPoint "flags" substantial risks regarding business and systems integration:

> The acquisition of the Spinco business is the largest and most significant acquisition FairPoint has undertaken. FairPoint's management will be required to

[95] See Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at pages 25-32.

devote a significant amount of time and attention to the process of integrating the operations of FairPoint's business and Spinco's business, which will decrease the time they will have to service existing customers, attract new customers and develop new services or strategies. Due to, among other things, the size and complexity of the Northern New England business and the activities required to separate Spinco's operations from Verizon's, FairPoint may be unable to integrate the Spinco business into its operations in an efficient, timely and effective manner. FairPoint's inability to complete this integration successfully could have a material adverse effect on the combined company's business, financial condition and results of operations.

All of the risks associated with the integration process could be exacerbated by the fact that FairPoint may not have a sufficient number of employees to integrate FairPoint's and Spinco's businesses or to operate the combined company's business. Furthermore, Spinco offers services that FairPoint has no experience in providing, the most significant of which are competitive local exchange carrier wholesale services. FairPoint's failure or inability to hire or retain employees with the requisite skills and knowledge to run the combined business, may have a material adverse effect on FairPoint's business. The inability of FairPoint's management to manage the integration process effectively, or any significant interruption of business activities as a result of the integration process, could have a material adverse effect on the combined company's business, financial condition and results of operations.

In addition, if the combined company continues to require services from Verizon under the transition services agreement after the one-year anniversary of the closing of the merger, the fees payable by the combined company to Verizon pursuant to the transition services agreement will increase significantly, which could have a material adverse effect on the combined company's business, financial condition and results of operations. The aggregate fees expected to be payable by the combined company under the transition services agreement for the six-month period following the merger will be approximately $132.9 million. However, if the combined company requires twelve months of transition services following the merger, the aggregate fees expected to be payable will be approximately $226.9 million.

…

In order to operate as the combined company, FairPoint will be required to identify, acquire or develop, test, implement, maintain and manage systems and processes which provide the functionality currently performed for the Northern New England business by over 600 systems of Verizon. Of these Verizon systems, approximately one third relate to customer sales, service and support. Another third of the Verizon systems support network monitoring and related field operations. The remaining Verizon systems enable finance, payroll, logistics and other administrative activities. Over 80% of the information systems used in support of the Northern New England business are Verizon proprietary systems.

FairPoint has entered into a master services agreement with an independent consulting firm to assist in the identification and integration of systems to be deployed following the merger. The collective experience and knowledge of FairPoint, the consulting firm (during the term of the master services agreement) and Verizon (during the pre-closing period and the period of the transition services agreement) will be essential to the success of the integration. The parties' inability or failure to implement successfully their plans and procedures or the insufficiency of those plans and procedures could result in failure of or delays in the merger integration and could adversely impact the combined company's business, results of operations and financial condition. This could require the combined company to acquire and deploy additional systems, extend the transition services agreement and pay increasing monthly fees under the transition services agreement.

The failure of any of the combined company's systems could result in its inability to adequately bill and provide service to its customers or meet its financial and regulatory reporting obligations. FairPoint is in the process of converting all of its companies to a single outsourced billing platform. FairPoint expects this conversion will be completed by the middle of 2007. FairPoint is investigating whether and to what extent certain modules of the outsourced billing and operational support services platforms will be used by the combined company. At the completion of this project, FairPoint expects to have a single integrated billing platform, which it expects to be able to use after the merger for billing and support of all of its customers. The failure of any of the combined company's billing and operational support services systems could have a material adverse effect on the combined company's business, financial condition and results of operations. FairPoint is also implementing new systems to provide for and meet financial and regulatory reporting obligations. A failure of these systems may result in the combined company not being able to meet its financial and regulatory reporting obligations.[96]

[96] See DB-P-2, FairPoint Amendment No. 4 to S-4, at pages 25-26.

These are significant and material risks that I do not find accounted for in the financial projections which FairPoint has provided in this case.

There is no precedent that I am aware of that shows a company with the size and characteristics of FairPoint successfully accomplishing the required integration of businesses and systems. The "Summary of Comparable Transactions" identifies acquiring companies, each of whom were larger than the acquired companies, and more importantly each of whom had developed an existing ILEC operational support and management systems—with the notable exception of The Carlyle Group in its acquisition of Verizon Hawaii.[97]

As noted by Raymond James, "the value maximizing equation for Verizon is to structure the deal as a Reverse Morris Trust then sell the spin-co to an existing company, <u>with extant management, back office and other required infrastructure</u> to run the combined company <u>so that value is not destroyed in creating such corporate infrastructure</u>".[98] Unlike the other "comparable transactions", FairPoint does not have in place management, back office or other required infrastructure and systems. This proposed

[97] See DB-P-2, FairPoint Amendment No. 4 to S-4, at Annex C-1, page 11.

[98] Exhibit DB-P-14, "VZ: Analyzing Future Line Sales Under Reverse Morris Trust Scenarios"; Telecommunications Services Wireline Industry Brief; Equity Research; Raymond James & Associates, Inc., January 30, 2007, at page 1, <u>emphasis added</u>.

acquisition occurs from a totally different perspective than previous FairPoint acquisitions.[99]

There are numerous unknowns regarding the development of back office systems including the length of time to develop, the cost to develop, training and productivity of employees with the newly developed systems, the extent to which existing Verizon data will be able to be managed effectively and in integrated fashion on the new systems, the extent to which developed systems effectively replicate or improve upon existing Verizon systems, the extent to which FairPoint will be able to effectively develop and operate systems in areas where it has no previous experience (e.g., CLEC and wholesale services), and the extent to which customer-affecting business activities will suffer significant interruption or not.

System problems can be detrimental financially, as shown by FairPoint's previous problems with billing systems. As FairPoint noted in its comparison of significant year to year changes, "Bad debt expense was $1.4 million higher in 2005 than 2004 due primarily to difficulties experienced in our billing conversion related to the delay of non-pay disconnect notices."[100]

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99 As noted earlier, it is a complete shift in thinking from FairPoint's previous acquisition mode to the proposed acquisition where management and operational systems have to be built from the ground up and integrated with existing and new employees and systems, with prospect of time delays and cost over-runs.

100 Exhibit DB-P-18, FairPoint Communications Form 10-K, March 14, 2006, at page 44.

Q. WHAT HAS BEEN THE EVOLUTION OF MAIN VENDORS AND TIME LINES FOR THE DEVELOPMENT, INTEGRATION AND IMPLEMENTATION OF OPERATIONAL AND MANAGEMENT SYSTEMS FOR FAIRPOINT?

A. As noted above, FairPoint has been converting from one vendor's platform to another for billing systems for its existing operations. Regarding the proposed transaction, FairPoint in a **<u>***BEGIN CONFIDENTIAL***</u>**

[101]

[102]

[103]

<u>*END CONFIDENTIAL***</u>**.[104]

Between the point in time of the July 12, 2006 Management Presentation to Verizon and the creation and execution of the transaction documents in January 2007, the parties made the determination to use Capgemini for systems development, integration and

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[101] See Exhibit DB-C-3, FairPoint first supplemental reply to OCA GI 1-51 and Exhibit DB-C-4 **<u>***BEGIN CONFIDENTIAL***</u>**
<u>*END CONFIDENTIAL***</u>**, at page 1762.

[102] Id., at page 1770.

[103] Id., at page 1773.

[104] Id., at pages 1774 – 1777.

conversion work pertaining to most systems, except for billing which was directed to *****BEGIN CONFIDENTIAL*****

*****END CONFIDENTIAL*****. [105]

Significantly, on July 9, 2007, FairPoint filed Form 8-K with the SEC. This filing addressed two events, one of which was execution of the First Amendment to the Master Services Agreement between FairPoint and Capgemini. The First Amendment adds the following to the FairPoint/Capgemini contract:

- "Draft" Work Order #2, under which Capgemini is to perform the implementation of customer relationship management and billing platform services;[106]
- Capgemini will perform the services "substantially defined" in the "draft" Work Order #2 for $13 million less a discount of $4 million;[107]
- FairPoint grants Capgemini a "perpetual, worldwide, paid-up license to use, copy modify and sublicense" any deliverables provided to FairPoint as set forth in a Work Order, except that Capgemini may not use, copy, modify and sublicense any of this to a competitor of FairPoint.[108]

Thus, Capgemini takes over responsibility for billing and customer relationship management software and systems from *****BEGIN CONFIDENTIAL*****

[105] Cost Model Teleconference, FairPoint/Labor intervenors/ OCA/ ME OPA/NH Staff, July 12, 2007, Washington DC.
[106] Exhibit DB-P-25, FairPoint Communications Form 8-K, July 9, 2007, Exhibit 2.2, at page 2.
[107] Exhibit DB-P-25, FairPoint Communications Form 8-K, July 9, 2007, Exhibit 2.2, at page 2.
[108] Exhibit DB-P-25, FairPoint Communications Form 8-K, July 9, 2007, Exhibit 2.2, at page 1 (unnumbered).

<u>*END CONFIDENTIAL***</u>.** The impact of this vendor change on the financial projections in terms of time and cost is not known to OCA or the Commission at this time. This is a good example of execution risk.

Further, the value of what FairPoint gave up to Capgemini to induce Capgemini to sign the amendment—a worldwide, paid up license to systems that FairPoint is paying many millions of dollars to develop—is not known to OCA or the Commission. It is not likely that FairPoint would have given up this value without having encountered some circumstance that made it "necessary" to give the value to Capgemini—e.g., schedule or resource difficulties under the current plan.

FairPoint's financial model projects *****<u>BEGIN HIGHLY CONFIDENTIAL***</u>**

<u>*END HIGHLY CONFIDENTIAL***</u>** costs will have been incurred by FairPoint for payments and settlements to the previous vendor for work done prior to the issuance of Work Order 2 to Capgemini. These costs are not known to OCA or the Commission. The impact on schedule is also not known. "Work Order 2" was still in "draft" form as of July 9.

Q. IS THERE RECOGNITION AMONG SECURITIES ANALYSTS OF INTEGRATION RISKS?

A. Yes. *****BEGIN CONFIDENTIAL*****

*****END CONFIDENTIAL*****[109]

- *****BEGIN CONFIDENTIAL***** *****END CONFIDENTIAL*****[110]
- *****BEGIN CONFIDENTIAL***** *****END CONFIDENTIAL*****[111]
- *****BEGIN CONFIDENTIAL*****

[109] See Exhibit DB-C-1, FairPoint's first and second supplemental reply to OCA GI 1-41 and Exhibit DB-C-2, *****BEGIN CONFIDENTIAL***** *****END CONFIDENTIAL*****, at page 1 (CFPNH 2588).

[110] See Exhibit DB-C-1, FairPoint's first and second supplemental reply to OCA GI 1-41 and Exhibit DB-C-2, *****BEGIN CONFIDENTIAL***** *****END CONFIDENTIAL*****, at page 1 (CFPNH 1498).

[111] See Exhibit DB-C-1, FairPoint's first and second supplemental reply to OCA GI 1-41 and Exhibit DB-C-2, *****BEGIN CONFIDENTIAL***** *****END CONFIDENTIAL*****, at page 1 (CFPNH 1010).

<u>*END CONFIDENTIAL***</u>**[112]

- **<u>***BEGIN CONFIDENTIAL***</u>**

<u>*END CONFIDENTIAL***</u>**[113]

<u>*BEGIN HIGHLY CONFIDENTIAL***</u>**

<u>*END HIGHLY CONFIDENTIAL***</u>**.[114]

Q. IF THE TRANSITION TO NEW SYSTEMS AND OPERATIONS IS NOT EXECUTED WELL, WOULD THIS IMPACT CONSUMERS?

A. Yes. It stands to reason that consumers would be impacted by a less-than-favorable execution of the proposed transition to new systems and operations that is inherent in the

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[112] See Exhibit DB-C-1, FairPoint's first and second supplemental reply to OCA GI 1-41 and Exhibit DB-C-2, **<u>***BEGIN CONFIDENTIAL***</u>** **<u>***END CONFIDENTIAL***</u>**, at page 1 (CFPNH 0800).

[113] See Exhibit DB-C-1, FairPoint's first and second supplemental reply to OCA GI 1-41 and Exhibit DB-C-2, **<u>***BEGIN CONFIDENTIAL***</u>** **<u>***END CONFIDENTIAL***</u>**, at page 1 (CFPNH 1349),

[114] See Exhibit DB-HCL2-12, FairPoint HSR Attachment, **<u>***BEGIN HIGHLY CONFIDENTIAL***</u>** **<u>***END HIGHLY CONFIDENTIAL***</u>**, at page 12 (CFPNH 2966).

proposed transaction. If the proposed transaction turns out to be not well executed, then customers would tend to receive lesser quality of service, or be exposed to other customer-dissatisfying circumstances. For example, if plant and provisioning systems do not interact properly with customer service systems, the FairPoint customer service representatives may experience difficulty in being able meet customer expectations regarding DSL ordering and commitments. Customer service quality and experience would also be impacted to the extent that FairPoint is not able to reach or maintain the necessary level of experienced employees. A further consequence of both service quality impacts is that the rate of access line loss to competitors, especially cable telephony, will be higher than it otherwise would be. The overall risk here is heightened by the fact that FairPoint is proposing to take over operations in three states that have experienced notable service quality problems in the years leading up to this proposed transaction.

Q. FAIRPOINT STATES, "THE COMBINED COMPANY MAY NOT REALIZE THE ANTICIPATED SYNERGIES, COST SAVINGS AND GROWTH OPPORTUNITIES FROM THE MERGER."[115] DID YOU REVIEW FAIRPOINT'S SYNERGY STATEMENTS AND CALCULATIONS?

A. Yes. In response to an OCA data request, FairPoint stated:

> Synergies are essentially the difference between the allocated costs that go away upon close and the incremental direct cost that FairPoint must incur post-close. Using 2007 as the comparison, we anticipate eliminating

[115] Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at page 26.

> approximately $100 million of the $222 million in allocated costs in areas such as Software Depreciation, Programming and Rents that are purely allocations to these properties from centralized workgroups and corporate facilities outside of the Verizon Northern New England footprint. Partially offsetting these savings are increased costs in areas such as Engineering & Operations and Finance & Accounting where we anticipate, among other things, additional personnel needs to replace the centralized functions that will no longer continue. These cost increases are expected to total approximately $45 million. The net of the eliminated allocations and increased direct costs is expected to be approximately $60 to $75 million on a run-rate basis following the successful integration.[116]

What this means is that the synergies calculation is entirely dependent on FairPoint's estimation of the eliminated allocations compared to its estimation of the costs it will incur. It is impossible to validate that these synergies will actually occur. The realization of these asserted synergies is dependent on the extent to which estimated Verizon allocations are correct, and the extent to which estimated FairPoint costs materialize as projected (which I address below pertaining to the financial model) . A more important driver of FairPoint's asserted synergies may be the fact that *****BEGIN CONFIDENTIAL*****

*****END CONFIDENTIAL*****.[117]

There is a substantial risk that the synergies will not be attained, and this risk is heightened by the fact that this proposed transaction is a complete shift for FairPoint, from acquiring a company and simply eliminating expenses by integration into existing

[116] Exhibit DB-P-26, FairPoint reply to OCA GI 1-31.

operations, versus acquiring a large geographic operation with a required development, integration and implementation of a complete "back office" for management and operational systems support. I have also addressed this subject in regard to "execution risk", and the subjects are clearly related. The likelihood of synergies achievement can also be assessed by referring to FairPoint's historical ability to control costs, which is addressed in my testimony regarding operating expenses in Section VI.C., below.

Q. DO THE SYNERGIES CALCULATIONS PROVIDED BY FAIRPOINT ON JULY 16, 2007,[118] CONTAIN CIRCULAR CALCULATIONS?

A. Yes. The Excel definition of a circular reference is when a formula refers back to its own cell, either directly or indirectly. In this case, *****BEGIN HIGHLY CONFIDENTIAL*****

*****END HIGHLY CONFIDENTIAL*****.

[117] Cost Model Teleconference, FairPoint/Labor intervenors/ OCA/ ME OPA/NH Staff, July 12, 2007, Washington DC.
[118] See Exhibit DB-HCL1-1, FairPoint's Reply to OCA FDR I-10 and *****BEGIN HIGHLY CONFIDENTIAL***** *****END HIGHLY CONFIDENTIAL***** (CFPNH 2370-2374).

Q. PLEASE INDICATE HOW FAIRPOINT'S FINANCIAL PROJECTIONS ADDRESS THIS RISK.

A. The projections assume the full synergy estimates, and growth opportunities are also included in the projections. FairPoint did not provide any sensitivity analyses, but did provide one "Material Adverse Change" ("MAC") scenario, designed essentially to assume no synergies.

Q. FAIRPOINT STATES, "AFTER THE CLOSE OF THE TRANSACTION, SALES OF FAIRPOINT COMMON STOCK MAY NEGATIVELY AFFECT ITS MARKET PRICE."[119] PLEASE DESCRIBE THE CIRCUMSTANCES THAT MIGHT TRIGGER THIS RISK.

A. According to the July 2 S-4A:

> The market price of FairPoint common stock could decline as a result of sales of a large number of shares of FairPoint common stock in the market after the completion of the merger or the perception that these sales could occur. These sales, or the possibility that these sales may occur, may also make it more difficult for the combined company to obtain additional capital by selling equity securities in the future at a time and at a price that it deems appropriate.
>
> Immediately after the merger, prior to the elimination of fractional shares, Verizon stockholders will collectively hold approximately 60% of FairPoint's common stock on a fully diluted basis (excluding treasury stock, certain specified options, restricted stock units, restricted units and certain restricted shares outstanding as of the date of the merger agreement). Currently, Verizon's common stock is included in index funds and exchange-traded funds tied to the Dow Jones Industrial Average and the Standard & Poor's 500 Index. Because FairPoint is not expected to be included in these indices at the time of the merger and may not meet the investing guidelines of certain institutional investors that may be

[119] Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at page 27.

> required to maintain portfolios reflecting these indices, these index funds, exchange-traded funds and institutional investors may be required to sell FairPoint common stock that they receive in the merger. These sales may negatively affect the combined company's common stock price.[120]

One of the "investing guidelines" that is known to affect portfolios of institutional investors is bond credit ratings. Verizon's credit rating is much higher than FairPoint's, and sale of FairPoint stock by institutional investors, post-closing of the transaction, could be triggered by the lower bond credit ratings of FairPoint, or by desire to hold another stock or investment with a lesser risk profile.

Q. FAIRPOINT STATES, "IF THE ASSETS TRANSFERRED TO SPINCO BY VERIZON ARE INSUFFICIENT TO OPERATE THE COMBINED COMPANY'S BUSINESS, IT COULD ADVERSELY AFFECT THE COMBINED COMPANY'S BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS."[121] PLEASE ADDRESS THIS RISK.

A. The July 2 S-4A states:

> Pursuant to the distribution agreement, the Verizon Group will contribute to Spinco (i) specified assets and liabilities associated with the local exchange business of Verizon New England in Maine, New Hampshire and Vermont, and (ii) the customers of the Verizon Group's related long distance and Internet service provider businesses in those states. See "The Distribution Agreement—Preliminary Transactions." The contributed assets may not be sufficient to operate the combined company's business. Accordingly, the combined company may have to use assets or resources from FairPoint's existing business or acquire additional assets in order to operate the Spinco business, which could adversely affect the combined company's business, financial condition and results of operations.

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[120] Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at page 27.
[121] Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at page 27.

> Pursuant to the distribution agreement, the combined company has certain rights to cause Verizon to transfer to it any assets required to be transferred to Spinco under that agreement which were not transferred as required. If Verizon were unable or unwilling to transfer those assets to the combined company, or Verizon and the combined company were to disagree about whether those assets were required to be transferred to Spinco under the distribution agreement, the combined company might not be able to obtain those assets or similar assets from others.[122]

FairPoint does not take possession of the operations until closing of the transaction, so it cannot know for sure that it will be receiving all assets necessary to operate the business. Of crucial importance, **<u>***BEGIN CONFIDENTIAL***</u>**

[123]

<u>*END CONFIDENTIAL***</u>.**[124] Importantly, FairPoint has stated that it "<u>does</u> "<u>does not</u> take the position that there is no need for network improvement or staffing changes, nor does FairPoint take the position that change in either is required."[125]

FairPoint senior management noted as one of several **<u>***BEGIN HIGHLY CONFIDENTIAL INFORMATION***</u>** "

[122] Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at page 27.
[123] See Exhibit DB-HCL1-2, FairPoint's Second Supplemental Reply to Staff GII 2-35, at 2 (unnumbered).
[124] See Exhibit DB-HCL1-2, FairPoint's Second Supplemental Reply to Staff GII 2-35, at 3 (unnumbered).
[125] See Exhibit DB-P-27, FairPoint's reply to OCA FDR II-34 (emphasis in original).

<u>*END HIGHLY CONFIDENTIAL***</u>**.[126] I did not find this to be accounted for in the financial projections and model . The FairPoint financial model **<u>***BEGIN HIGHLY CONFIDENTIAL INFORMATION***</u>**

<u>*END HIGHLY CONFIDENTIAL***</u>**. FairPoint will not know whether it has sufficient resources for the network, or the extent to which network improvements beyond what it has planned will be necessary or not until following close of the transaction.

Q. HAS FAIRPOINT HISTORICALLY INVESTED MORE IN THE NETWORK THAN THAT NECESSARY FOR DSL AVAILABILITY?

A. **<u>***BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION***</u>**

<u>*END HIGHLY CONFIDENTIAL HSR INFORMATION***</u>**[127]

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[126] See Exhibit DB-HCL2-11, FairPoint HSR Attachment 4(c)-11, March 1, 2006 e-mail from Peter Nixon to Walter Leach, at page 1 (CFPNH HSR 0228).

[127] Exhibit DB-HCL2-13, Verizon HSR Attachment, 4(c)-7, <u>*****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****</u> <u>*****END HIGHLY CONFIDENTIAL HSR INFORMATION*****</u>

Q. FAIRPOINT STATES, "THE COMBINED COMPANY'S BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS MAY BE ADVERSELY AFFECTED FOLLOWING THE MERGER IF IT IS NOT ABLE TO REPLACE CERTAIN CONTRACTS WHICH WILL NOT BE ASSIGNED TO SPINCO."[128] PLEASE DESCRIBE AND ADDRESS THIS RISK.

A. The July 2 S-4A states:

> Certain contracts, including supply contracts and interconnection agreements used in the Northern New England business, will not be assigned to Spinco by Verizon. Accordingly, the combined company will have to obtain new agreements for the goods and services covered by these supplier and interconnection agreements in order to operate the Spinco business following the merger. There can be no assurance that FairPoint will be able to replace the supplier and interconnection agreements on terms favorable to it or at all. FairPoint's failure to enter into new agreements prior to the closing of the merger may have a material adverse impact on the combined company's business, financial condition and results of operations following the merger.
>
> In addition, certain wholesale, large business, Internet service provider and other customer contracts which are required to be assigned to Spinco by Verizon require the consent of the customer party to the contract to effect this assignment. Verizon and the combined company may be unable to obtain these consents on terms favorable to the combined company or at all, which could have a material adverse impact on the combined company's business, financial condition and results of operations following the merger.[129]

[128] Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at page 28
[129] Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at page 28.

Q. FAIRPOINT STATES, "FAIRPOINT'S OR THE COMBINED COMPANY'S SPENDING IN EXCESS OF THE BUDGETED AMOUNTS ON INFRASTRUCTURE AND NETWORK SYSTEMS INTEGRATION AND PLANNING RELATED TO THE MEGER COULD ADVERSELY AFFECT FAIRPOINT'S OR THE COMBINED COMPANY'S BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS."[130] PLEASE ADDRESS THIS RISK.

A. This risk tends to arise from the fact that this acquisition scenario is completely different from previous FairPoint acquisitions. FairPoint must design, develop, integrate and implement numerous managerial and operational support systems, numbering in the hundreds. These systems must function properly together in order to provide all aspects of "Telco" operations which have been operated by Verizon in an integrated fashion. There is no "off the shelf" integrated system for this, and FairPoint and Verizon are spending hundreds of millions of dollars in an attempt to accomplish the development and transition. FairPoint at the beginning underestimated the complexity, cost and time for the task, and may still be exposed to time and cost increases as shown by the recent change of vendor for the customer relationship management and billing function development and implementation, represented by "draft Work Order #2" to the

[130] Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at page 28.

Capgemini Master Services Agreement. Information to show tracking of development and transition expenses has been requested from FairPoint, but has not yet been provided.

B. Risks to the Company's Business Following the Merger

Q. PLEASE ADDRESS THE SECOND CATEGORY OF RISK FACTORS, THE RISKS TO THE COMPANY'S BUSINESS FOLLOWING THE MERGER.

A. FairPoint enumerates these risks as follows:

1. "FairPoint and Spinco provide services to customers over access lines, and if the combined company loses access lines, its business, financial condition and results of operations may be adversely affected."

2. "The combined company will be subject to competition that may adversely impact its business, financial condition and results of operations."

3. "The combined company may not be able to successfully integrate new technologies, respond effectively to customer requirements or provide new services."

4. "The geographic concentration of the combined company's operations in Maine, New Hampshire and Vermont following the merger will make its business susceptible to local economic and regulatory conditions, and an economic downturn, recession or unfavorable regulatory action in any of those states may adversely affect the combined company's business, financial condition and results of operations."

5. "To operate and expand its business, service its indebtedness and complete future acquisitions, the combined company will require a significant amount of cash. The combined company's ability to generate cash will depend on many factors beyond its control. The combined company may not generate sufficient funds from operations to pay dividends with respect to shares of its common stock, to repay or refinance its indebtedness at maturity or otherwise, or to consummate future acquisitions."

6. "The combined company's stockholders may not receive the level of dividends provided for in the dividend policy FairPoint's board of directors has adopted or any dividends at all."

7. "If the combined company has insufficient cash flow to cover the expected dividend payments under its dividend policy due to costs associated with the merger or other factors, it will be required to reduce or eliminate dividends or, to the extent permitted under the agreements governing its indebtedness, fund a portion of its dividends with additional borrowings."

8. "The combined company's substantial indebtedness could restrict its ability to pay dividends on its common stock and have an adverse impact on its financing options and liquidity position."

9. "FairPoint Communications, Inc. is a holding company and relies on dividends, interest and other payments, advances and transfers of funds from its operating subsidiaries and investments to meet its debt service and other obligations."

10. "It is expected that the combined company's new credit facility and other agreements governing its indebtedness will contain covenants that will limit its business flexibility by imposing operating and financial restrictions on its operations and the payment of dividends."

11. "Limitations on the combined company's ability to use net operating loss carryforwards, and other factors requiring the combined company to pay cash to satisfy its tax liabilities in future periods, may affect its ability to pay dividends to its stockholders."

12. "The combined company's business, financial condition and results of operations could be adversely affected if the combined company fails to maintain satisfactory labor relations."

13. "The combined company faces risks associated with acquired businesses and potential acquisitions."

14. "A network disruption could cause delays or interruptions of service, which could cause the combined company to lose customers."

15. "The combined company's relationships with other communications companies will be material to its operations and their financial difficulties may adversely affect its future business, financial condition and results of operations."

16. "The combined company will depend on third parties for its provision of long distance and bandwidth services."

17. "The combined company may not be able to maintain the necessary rights-of-way for its networks."

18. "The combined company's success will depend on its ability to attract and retain qualified management and other personnel."

19. "The combined company may face significant future liabilities or compliance costs in connection with environmental and worker health and safety matters."

20. "The combined company will be exposed to risks relating to evaluations of controls required by Section 404 of the Sarbanes-Oxley Act."[131]

I will particularly focus on factors 1-3, 5-10, 12, 15, and 18, above.

[131] Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at pages 32-42.

Q. FAIRPOINT STATES, "THE COMBINED COMPANY WILL BE SUBJECT TO COMPETITION THAT MAY ADVERSELY IMPACT ITS BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS"[132] AND REFERS TO POTENTIAL LOSS OF ACCESS LINES. PLEASE DESCRIBE YOUR UNDERSTANDING OF FAIRPOINT'S CURRENT VIEW OF COMPETITION.

A. The July 2 S-4A states, "is one of the largest telephone companies in the United States focusing on serving rural and small urban communities".[133] It "believes that in many of its markets, it is the only service provider that offers customers an integrated package of local and long distance voice, high speed data, and Internet access as well as a variety of enhanced services such as voice mail and caller identification."[134] The July 2 S-4A further states in regards to projections for the proposed transaction, "on a standalone basis without giving effect to the merger, FairPoint assumed continued, but slowing, access line losses in the Spinco business as the result of overall industry trends such as cable competition and use by customers of alternative technologies. FairPoint believed that it would be able to mitigate access line losses in the Spinco business with regionally-focused marketing, bundling, win-back strategies and the substantially increased availability of its broadband product in Maine, New Hampshire and Vermont."[135] FairPoint states, *****BEGIN HIGHLY CONFIDENTIAL*****

[132] Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at page 32.
[133] Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at page 24.
[134] Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at page 24.
[135] Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at page 79.

<u>*END HIGHLY CONFIDENTIAL***</u>**". [136]

Q. PLEASE STATE THE COMPETITION RISK AS DESCRIBED BY FAIRPOINT.

A. The July 2 S-4A states:

> As an incumbent carrier, FairPoint historically has experienced little competition in its rural telephone company markets; however, many of the competitive threats now confronting large regulated telephone companies, such as competition from cable television providers, will be more prevalent in the small urban markets which the combined company will serve following the merger. Regulation and technological innovation change quickly in the communications industry, and changes in these factors historically have had, and may in the future have, a significant impact on competitive dynamics. In most of its rural markets, FairPoint faces competition from wireless technology, which may increase as wireless technology improves. FairPoint also faces, and the combined company may face, increasing competition from cable television operators. The combined company may face additional competition from new market entrants, such as providers of wireless broadband, voice over Internet protocol, referred to as VoIP, satellite communications and electric utilities. The Internet services market is also highly competitive, and FairPoint expects that this competition will intensify. Many of FairPoint's competitors (who will also be competitors of the combined company) have brand recognition, offer online content services and have financial, personnel, marketing and other resources that are significantly greater than those of FairPoint and may be greater than those of the combined company. Verizon has informed FairPoint of its current intention to compete with the combined company by continuing to provide the following services in the northern New England areas in which the combined company will operate:
>
> - the offering of long distance services and prepaid card services and the resale of local exchange service;
> - the offering of products and services to business and government

[136] See Exhibit DB-HCL2-14, FairPoint HSR Attachment 4(c)-7, FairPoint presentation on Marketing, Product, and Sales Channels, page 14 (unnumbered) (CFPNH HSR 0191).

customers other than as the incumbent local exchange carrier, including but not limited to carrier services, data customer premises equipment and software, structured cabling, call center solutions and the products and services formerly offered by MCI, Inc.; and

- the offering of wireless voice, wireless data and other wireless services.

The combined company will offer local exchange and long distance services in Maine, New Hampshire and Vermont and will compete with Verizon to provide these services. To the extent that the combined company offers services to businesses and government customers in these states, it will also compete directly with Verizon. Although Verizon could compete with the combined company in the offering of long distance services to residences and small businesses, Verizon does not actively market the sale of these services to residences and small businesses in Maine, New Hampshire and Vermont, other than through the Northern New England business. If the combined company enters into an agreement with Verizon or another wireless services provider to be a mobile virtual network operator, referred to as MVNO, it will compete with Verizon to provide wireless services in those areas where the Northern New England business and Cellco currently operate.

In addition, consolidation and strategic alliances within the communications industry or the development of new technologies could affect the combined company's competitive position. FairPoint cannot predict the number of competitors that will emerge, particularly in light of possible regulatory or legislative actions that could facilitate or impede market entry, but increased competition from existing and new entities could have a material adverse effect on the combined company's business, financial condition and results of operations.

Competition may lead to loss of revenues and profitability as a result of numerous factors, including:

- loss of customers;
- reduced network usage by existing customers who may use alternative providers for long distance and data services;
- reductions in the service prices that may be necessary to meet competition; and
- increases in marketing expenditures and discount and promotional campaigns.

In addition, the combined company's provision of long distance service will be

> subject to a highly competitive market served by large nationwide carriers that enjoy brand name recognition.[137]

Q. HAS THE THREE STATE AREA EXPERIENCED SIGNIFICANT COMPETITION FROM CABLE COMPANIES, IN TERMS OF HIGH SPEED INTERNET AND CABLE TELEPHONY?

A. It appears that competition in these services has been relatively muted compared to other areas due to the legal problems experienced by Adelphia in recent years. Adelphia provided significant service in New Hampshire and Maine. Adelphia's problems have culminated in sale of the company. According to Verizon, *****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****

*****END HIGHLY CONFIDENTIAL HSR INFORMATION*****.[138]

Q. IS VERIZON RESTRICTED FROM COMPETING WITH FAIRPOINT, POST-TRANSACTION?

A. No. As stated in FairPoint's July 2 S-4A, "the merger agreement and the distribution

[137] Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at page 32-33.

[138] See Exhibit DB-HCL2-15, Verizon HSR Attachment 4(c)-9, *****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION***** *****END HIGHLY CONFIDENTIAL HSR INFORMATION*****

agreement do not contain any restrictions on Verizon's ability to compete with the combined company following the merger."[139] Verizon retains certain enterprise customers and the former MCI operation and customer knowledge derived from those businesses, and would potentially be able to expand services in competition with FairPoint. The retained businesses include:

- Verizon Business Global (which includes the business of MCI), providing local, long distance and enhanced services "principally to enterprise and government customers over owned and resold networks;"[140]
- Cellco Partnership (d/b/a Verizon Wireless) "will market, sell and deliver wireless services;"[141]
- Verizon Network Integration, providing "non-LEC network integration services to commercial and government services;"[142]
- Verizon Federal Inc., providing "customized communications systems integration and converged solutions to federal civilian and defense government agencies, state & local government, and education customers;"[143]
- Verizon Federal Network Systems LLC, providing "federal government customers

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139 Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at page 106.
140 Direct Testimony of Stephen E. Smith on behalf of Verizon New England, at page 19.
141 Id.
142 Id.
143 Id.

with enterprise-wide communications solutions and professional services";[144]

- Verizon Global Networks Inc. "will maintain long distance networks used by Verizon affiliates and third parties;"[145]
- NYNEX LD and BACI "will retain their state and federal long distance authority in order to terminate long distance traffic in the three states;" and
- VSSI "will offer prepaid card, payphone dial-around services and dedicated internet access services."[146]

"While VNE will terminate its authority to conduct business in Maine, New Hampshire and Vermont, all Verizon affiliates will retain the right to offer Voice over Internet Protocol services to customers in those markets."[147] Verizon also retains its Voice over IP service, and obviously wireless services and could compete with FairPoint post-transaction using those modes. As FairPoint states, "Following the transaction, FairPoint will be independent from and will compete with Verizon, including Verizon Business and Verizon Wireless."[148]

One place where competition of Verizon and FairPoint could impact FairPoint's

[144] Id.
[145] Id.
[146] Direct Testimony of Stephen E. Smith on behalf of Verizon New England, at page 20.
[147] Direct Testimony of Stephen E. Smith on behalf of Verizon New England, at page 20.
[148] Exhibit DB-P-11, Verizon's and FairPoint's "Opposition to Petitions to Deny", WC Docket No. 07-22, before the Federal Communications Commission, May 7, 2007, at page 32 (FPNH 0804).

projections is regarding FairPoint's Enterprise Revenue assumption, where it "assumed total average revenue per unit for the Spinco business would increase 26% versus 2006 levels by 2012 as the Spinco business captured a greater percentage of the overall spending by Enterprise customers."[149] I would expect over time that Verizon would seek to sell all services to Enterprise accounts, rather than sharing with FairPoint, and also FairPoint's complete lack of historical experience with Enterprise level customers would tend to make it much more difficult to retain these customers and revenues.

Q. HOW DO FAIRPOINT'S FINANCIAL MODEL PROJECTIONS ADDRESS THE COMPETITIVE RISK FACTORS IDENTIFIED IN THE FORM S-4A?

A. Not adequately. I will explain this in more detail below in addressing the financial model. In summary, I do not believe the model inputs and assumptions adequately address competitive risk primarily due to failure to account for losses to cable telephony, or the impact Verizon will have post-closing.

Q. FAIRPOINT REFERS TO A NUMBER OF RISKS RELATED TO FINANCIAL MATTERS. PLEASE ADDRESS THESE RISKS.

A. The July 2 S-4A notes a number of risks that include that the combined company will require a lot of cash and that it may not generate sufficient funds to pay dividends, and debt and debt interest; the company may cut or eliminate the dividend or add debt to pay it; and, the company's substantial indebtedness could have an adverse effect on its

[149] Exhibit DB-P-8, FairPoint Amendment No. 5 to S-4, at page 80.

financing options and liquidity position. All these risks are indeed present and exacerbated by FairPoint's high debt leverage. FairPoint is not able to project paying down a substantial portion of its long term liabilities since it consumes almost all its cash for interest payments, dividend payments, operating expenses, taxes, and capital expenditures. The financial projections are tight, and vulnerable to changed business and market conditions beyond FairPoint's control. These risks are substantial.

Q. FAIRPOINT STATES, "THE COMBINED COMPANY'S BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS COULD BE ADVERSELY AFFECTED IF THE COMBINED COMPANY FAILS TO MAINTAIN SATISFACTORY LABOR RELATIONS."[150] PLEASE ADDRESS THIS RISK.

A. The July 2 S-4A states:

> Following the merger, approximately 67% of the combined company's employees will be members of unions employed under seven collective bargaining agreements. The two principal collective bargaining agreements to which Verizon is currently a party expire in August 2008. Upon the expiration of any of these collective bargaining agreements, the combined company may not be able to negotiate new agreements on favorable terms to the combined company or at all. Furthermore, the process of renegotiating the collective bargaining agreements could result in labor disputes or other difficulties and delays. These potential labor disruptions could have a material adverse effect on the combined company's results of operations and financial condition. In the event of any work stoppage or other disruption, the combined company will be required to engage third-party contractors. Labor disruptions, strikes or significant negotiated wage increases could reduce the combined company's sales or increase its costs and accordingly, could have a material adverse effect on its business, financial condition and

[150] Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at page 39.

> results of operations.
>
> Currently, both of the labor unions representing Spinco employees have objected to the merger in certain regulatory proceedings. The International Brotherhood of Electrical Workers has filed four grievances alleging that the transaction violates their collective bargaining agreements with respect to job security, benefit plans, transfer of work and hiring restrictions. The grievances seek remedies which include an order to cease and desist from the alleged prohibited actions, an order to follow the contract terms, and an order to take remedial actions. Verizon has denied any violation of the collective bargaining agreements and has asserted defenses to these grievances. The job security and transfer of work grievances have been submitted to arbitration under the labor arbitration rules of the American Arbitration Association pursuant to the parties' collective bargaining agreements. Hearings on those grievances are scheduled to begin in mid-July and conclude by the end of August. It is anticipated that hearings on the benefit plans and hiring restrictions grievances will be scheduled shortly.[151]

I do not find labor relations issues accounted for in any way in the financial projections, or the model. The financial projections and the model appear to simply project the status quo forward in regards to labor.

I view the labor relations issue as very significant, since the relevant unions have a stated opposition to the proposed transaction. *****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****

*****END HIGHLY CONFIDENTIAL HSR INFORMATION***** [152]

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[151] Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at page 39.

[152] See Exhibit DB-HCL2-7, Verizon HSR Attachment 4(c)-4, *****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION***** *****END HIGHLY CONFIDENTIAL HSR INFORMATION*****

Q. HOW DOES THE FINANCIAL MODEL AND PROJECTIONS ADDRESS LABOR COSTS AND PENSIONS AND OTHER BENEFITS?

A. The model indicates that FairPoint currently has no expenses for either employee pensions or other post employment benefits (OPEB), and the model does not assume these expenses for newly hired "incremental" employees**.**

Pension and OPEB costs were evidently a disputed issue between FairPoint and Verizon in negotiating the agreement, and this issue contributed to rejection of the transaction by the FairPoint Board of Directors on September 20, 2006.[153] Moreover, this issue will likely be a very large management issue for FairPoint, based also on consideration of the active role being taken in this case by the Labor intervenors.

Q. FAIRPOINT STATES, "THE COMBINED COMPANY'S SUCCESS WILL DEPEND ON ITS ABILITY TO ATTRACT AND RETAIN QUALIFIED MANAGEMENT AND OTHER PERSONNEL."[154] PLEASE ADDRESS THIS RISK.

A. The July 2 S-4A further states, "FairPoint's success depends, and the success of the combined company will depend, upon the talents and efforts of FairPoint's senior management team. … The loss of any member of the combined company's senior management team, … could have material adverse effect on the combined company's

[153] Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, "Background of the Merger", pages 55-60.

business, financial condition and results of operations."[155] While this is a noteworthy risk factor, risks pertaining to the loss of "other personnel" exist as well.

Employees in the three states **<u>***BEGIN HIGHLY CONFIDENTIAL***</u>** **<u>***END HIGHLY CONFIDENTIAL***</u>** over the period in which this transaction has been considered. In mid-2006, the three state operation had **<u>***BEGIN HIGHLY CONFIDENTIAL***</u>** **<u>***END HIGHLY CONFIDENTIAL***</u>** employees.[156] A more recent employee count is 2,700 to 2,800 employees, as of May 2007.[157] This is **<u>***BEGIN HIGHLY CONFIDENTIAL***</u>** **<u>***END HIGHLY CONFIDENTIAL***</u>** percent of the employee base. Accordingly, **<u>***BEGIN HIGHLY CONFIDENTIAL***</u>** **<u>***END HIGHLY CONFIDENTIAL***</u>**.

FairPoint, in announcing the proposed transaction, indicated an intention to hire 600 employees. In recent announcements, however, this figure increased to 675.[158] The

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154 Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at page 41.
155 Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at page 41.
156 See Exhibit DB-HCL2-16, FairPoint HSR Attachment 4(c)-5, "Project Nor'easter Management Presentation" – June 2006 prepared by Verizon, page 10 (CFPNH HSR 0082).
157 Rebuttal Testimony of Peter G. Nixon, Docket No. 7270 before the Vermont Public Service Board, page 14, line 6.
158 See Exhibit DB-P-4, "FairPoint promises 675 new jobs if Verizon deal goes through, Business Review, July6, 2007.

reason for the need for an increased number of employees is not clear, as the OCA is only aware of the change through press reports.

The financial model indicates **<u>***BEGIN HIGHLY CONFIDENTIAL***</u>** **<u>***END HIGHLY CONFIDENTIAL</u>***** employees for the three-state operation. FairPoint **<u>***BEGIN HIGHLY CONFIDENTIAL***</u>** **<u>***END HIGHLY CONFIDENTIAL***</u>**[159]

Q. FAIRPOINT NOTES RISKS FROM THE COMBINED COMPANY'S RELATIONSHIPS WITH OTHER COMMUNICATIONS COMPANIES, AND THEIR FINANCIAL DIFFICULTIES ADVERSELY AFFECTING FAIRPOINT.[160] PLEASE ADDRESS THIS RISK.

A. This risk appears at least partially a reference to uncollectible billings to CLECs when the CLEC goes bankrupt, a circumstance which was a large scale issue when MCI was in bankruptcy (as well as other smaller companies). There will continue to be some risk of this, but presumably the exposure is not so large since the largest CLECs (AT&T and MCI) have been acquired by ILECs, and the CLEC business has been declining overall since the required offering of UNEs (especially UNE-P) was substantially reduced by the

[159] See Exhibit DB-HCL2-2, FairPoint HSR Attachment 4(c)-9, CEO Conference July 25, 2006 "Highly Confidential" –

FCC. But there is a new risk to FairPoint from its assumption of major wholesale operations and responsibilities when FairPoint has never had such operations or responsibilities in the past. This is compounded by the fact that FairPoint must develop CLEC operations and systems "from scratch".

Q. SHOULD THE COMMISSION VIEW THIS ENUMERATION OF RISKS AS IMPORTANT?

A. Yes. The enumerated risks are clearly relevant or they would not be placed in the Form S-4A filing by FairPoint. Furthermore, as stated in The Wall Street Journal:

> By law, prospectuses for initial public offerings of stock must contain a section entitled "risk factors. These lay out, often in skull-numbing detail, all of the things that could go wrong for a firm making its debut. Not surprisingly, as the U.S. has become more litigious, these litanies of disaster have grown over the years. As a result, investors may be tempted to treat them as meaningless boilerplate. That would be foolish. … Reading through the fine print of the prospectuses may be a chore. But it is the one time when companies must put their spin machines on hold. Read the risk factors.[161]

FairPoint personnel only, at page 5 (CFPNH HSR 0216).

[160] See Exhibit DB-P-8, FairPoint Amendment No. 5 to S-4, at page 40.

[161] Exhibit DB-P-28, "Read the 'Risk Factors': Far from Empty Boilerplate, IPO Prospectuses Lay Out Debutant Firms' Red Flags", The Wall Street Journal, June 16, 2007.

VI. FairPoint's Financial Model and Financial Projections

A. The Model

Q. HAVE YOU RECEIVED AND REVIEWED THE FINANCIAL MODEL THAT WAS THE BASIS FOR THE FINANCIAL PROJECTIONS CONTAINED IN INVESTMENT ADVISOR REPORTS AND ANALYSES FOR FAIRPOINT, AND IN MR. LEACH'S TESTIMONY IN THIS CASE?

A. Yes.

Q. WAS THIS FINANCIAL MODEL PROVIDED TO ALL PARTIES IN THIS CASE?

A. My understanding is that it was not provided to all parties, and was provided only to OCA, the OCA's consultants, the Commission staff and its consultants, and, earlier this month, an attorney and a consultant for the labor intervenors.

Q. WHAT IS YOUR PERSPECTIVE ON COST OR FINANCIAL MODELING GENERALLY?

A. My view that it is very important to understand that cost modeling and cost or financial projections are simply estimations. Cost models and model results are not innately "correct" or accurate, but instead are simply estimations that are based on assumptions, data and mathematical formulas. For this reason, my review of the FairPoint financial model and its results was focused on identifying assumptions, sources of data and formulas in the spreadsheets. One overall objective was to ensure that "point of beginning" data—that from which projections of future years is made—traced to an external source, or at least one which is verifiable.

Q. WHAT OVERALL PATTERNS WERE DISCERNABLE FROM THE ILEC FINANCIAL DATA PRESENTED BY VERIZON?

A. The financial data showed **<u>***BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION***</u>**

<u>*END HIGHLY CONFIDENTIAL HSR INFORMATION***</u>**[162]

However, this data would not include the full effect of cable telephony offerings in the former Adelphia areas recently acquired by Time Warner and Comcast. Full roll out and

[162] See Exhibit DB-HCL2-16, FairPoint HSR Attachment 4(c)-5, "Project Nor'easter Management Presentation" – June

marketing of cable telephony by the other facilities based carriers in the Verizon territory can be expected to have a significant impact, based on experience from other jurisdictions, as I note elsewhere in this testimony. The data also would not include ongoing CLEC contraction due to elimination of UNE availability, particularly UNE-P in 2005. The elimination of UNE-P fundamentally diminished the CLEC mode, as illustrated by the two predominant CLECs—AT&T and MCI—being driven out of independent existence into acquisition by the two largest ILECs—Verizon and SBC.

Q. DOES THE DATA IN FAIRPOINT'S FINANCIAL MODEL TRACE BACK TO VERIFIABLE EXTERNAL DATA OR CALCULATIONS?

A. No. In general, the FairPoint financial model data do not source back to verifiable, identifiable external data, particularly on the cost side. Therefore, the projections themselves do not have a verifiable, reviewable source. This is a major concern that I have with the model as presented. This concern undercuts the validity of the resultant financial projections for use in this proceeding, and the Commission should share this major concern. From my review of the model, the concern is ultimately so fundamental and serious that I do not believe the Commission can rely on projection results from the model to demonstrate financial viability of the proposed transaction, and FairPoint's financial viability going forward assuming the proposed transaction were to occur.

2006 prepared by Verizon., pages 94-95 (CFPNH HSR 0166-0167).

Q. PLEASE DESCRIBE THE CONTENTS AND NATURE OF FAIRPOINT'S FINANCIAL MODEL.

A. The financial model as provided by FairPoint is an Excel workbook which includes multiple worksheets. There are some formula links between the worksheets, but places where input changes in one place do not flow through to other calculations or worksheets are much more predominant. For example, if revenues are changed, uncollectibles expense remains as it was previously calculated, since it is hard coded. As another example, it is not possible in the model to vary the number of employees, and have the effect of changed labor costs flow through to model results. The model used by FairPoint is evidently based on a template developed by Lehman Brothers. The nature of the model with the various worksheets and cells which are not linked by formulas is that a global update or change is a very significant task to accomplish. Lehman Brothers had a significant role in the creation and maintenance of the model, and according to FairPoint, it is "very difficult to make changes and do scenarios".[163] The model consists of <u>*****BEGIN HIGHLY CONFIDENTIAL*****</u>

[163] Statements made by FairPoint personnel during technical sessions, June 4-6, 2007; and Cost Model Teleconference, FairPoint/Labor intervenors/ OCA/ ME OPA/NH Staff, July 12, 2007, Washington DC.

[164]

164

*****END HIGHLY CONFIDENTIAL*****.

Q. IS THE SAME LEVEL OF DETAIL PRESENT IN THE MODEL FOR BOTH FAIRPOINT AND THE THREE STATE VERIZON OPERATION?

A. *****BEGIN HIGHLY CONFIDENTIAL*****

*****END HIGHLY CONFIDENTIAL*****.

B. Model Projections and Review

Q. ARE FAIRPOINT'S FINANCIAL MODEL RESULTS THE "SAME" AS "FAIRPOINT'S SUMMARY PROJECTIONS FOR THE COMBINED COMPANY" CONTAINED IN ITS JULY 2, 2007 S-4A, AT PAGES 74 – 77[165]?

[165] See Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at page 74-77.

A. The results are closely similar up to the point of pro forma EBITDA, so I will tend to use the public information where I can, rather than confidential model information. Noticeable differences using 2009 for comparison are depreciation and amortization (in the model amortization of the customer list is higher, and depreciation expense is $31 million lower); interest expense (higher in the public projection by $13 million); income taxes (higher in the model as would be expected given the above); and annual net cash flows (increasingly higher over time in the public projection compared to the model). Capital expenditures are the same**.**

Q. WHAT DOES FAIRPOINT STATE WITH REGARD TO THE PROJECTIONS CONTAINED IN THE JULY 2, 2007 S-4A?

A. "These financial projections were prepared in January 2007, based solely on information available at the time, by FairPoint's management. … the financial projections do not reflect FairPoint's current view on the business of the combined company. **Therefore, these financial projections should not be considered a reliable predictor of future operating results.**"[166] FairPoint further states,

> the financial projections were, at the time made, based on then current information and assumptions which are subject to change as conditions develop. FairPoint has not updated and does not intend to update or otherwise revise these projections to reflect circumstances existing since their preparation or to reflect the occurrence of unanticipated events even in the event that any or all of the underlying assumptions are shown to be in error. Furthermore, FairPoint has not updated and does not intend to

[166] Exhibit DB-P-2, FairPoint Amendment No. 4 to S-4, at page 74 (emphasis in original).

> update or revise these projections to reflect changes in general economic or industry conditions.[167]

Q. SHOULD THIS CONCERN THE COMMISSION?

A. Yes. The OCA is concerned and the Commission should be concerned that it is being asked to approve a proposed transaction based on "projections [that] do not reflect FairPoint's current view on the business of the combined company", and "should not be considered a reliable predictor of future operating results." FairPoint should be required to provide the Commission with its "current view" on the business of the combined company, with data that can and should be considered a reliable predictor of future operating results, <u>before</u> the Commission makes its determination on the proposed transaction.

Q. HOW DID YOU CONDUCT YOUR REVIEW OF THE FAIRPOINT FINANCIAL MODEL?

A. I reviewed the model to:

- determine the extent to which figures and source data were traceable to external sources so that assumptions and quality of the data were clear;
- evaluate the presence or absence of traceable formulas, particularly those used to generate the numbers that populate the cells in the "Model" results page;
- evaluate what factors would materially affect the results or outputs of the model; and

[167] Id.

- determine the extent to which figures were "hard coded" into the model rather than resulting from formulas and formula references.

Q. DO YOU HAVE CONCERNS REGARDING THE TRACEABILITY OF INPUT DATA TO EXTERNAL SOURCE DOCUMENTATION?

A. Yes. The historical financial information (years 2005 and prior) contained in the model in some cases appear to be consistent and reasonably traceable to external data sources, *****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION***** *****END HIGHLY CONFIDENTIAL HSR INFORMATION***** *****BEGIN HIGHLY CONFIDENTIAL*****

*****END HIGHLY CONFIDENTIAL***** the FairPoint Form 10-K for 2006 indicates total operating expenses of $155 million. *****BEGIN HIGHLY CONFIDENTIAL***** *****END HIGHLY CONFIDENTIAL***.** Verizon direct salaries and wages for the three states in 2005 are indicated to be *****BEGIN HIGHLY CONFIDENTIAL** *****END**

HIGHLY CONFIDENTIAL***.[168] This is *****BEGIN HIGHLY CONFIDENTIAL*****

*****END HIGHLY CONFIDENTIAL*****.

Q. DID YOU IDENTIFY MATERIAL INSTANCES WHERE FIGURES WERE "HARD CODED" INTO THE FINANCIAL MODEL, SUCH THAT ASSUMPTIONS, FORMULAS OR SOURCE OF THE DATA WERE NOT TRANSPARENT?

A. Yes. The term "hard coded" to me means that the number has been input into the spreadsheet cell without indicated source information or formula calculation to show how the figure was derived. The input number may appear as a result of a previous formula or other program output, with the formulas eliminated leaving only the value. In many cases, this value extends to 8 or 13 places to the right of the decimal point, which clearly indicates someone did not physically input all those values. I have identified the larger blocks of "hard coded" information by spreadsheet in the model, as follows:

- "OpEx Buildup"

[168] See Exhibit DB-HCL2-17, FairPoint HSR Attachment 4(c)-1, Letter opening negotiations, Attachment 6C (CFPNH HSR

- Verizon 2005 “Salaries and wages – Existing” is composed of an untraceable formula of hard coded figures: “169503000 + 4890350 + 6770050 * 1.0899”. [Cell E27]
- Verizon 2005 “Salaries and wages – Incremental” is composed of an untraceable formula of hard coded figures: “45274000 + 4663350 + 6310000 + 2000000”. [Cell E28]
- FairPoint 2006 costs are hard coded
- Total Revenues and Access revenues are hard coded
- Projected 2007 expenses are essentially hard coded, directly or indirectly, and subsequent years are projected off these costs, so in essence the entire projection of operating expenses is hard coded.

- “Nov P & OPEB Schedule”
  - Inputs are entirely hard coded.
  - Results flow into “OpEx Buildup”, cells F35 and F39.
- “2007-2008 Spend”; expense schedule for this period, including Transaction costs, Transition costs, and employee costs associated with ramped up hiring.
  - The transaction costs appear to be budget assumptions, transition costs include spreading of Capgemini costs on a monthly basis along with other costs that appear to be budgetary in nature.

0017).

  - Inputs are generally hard coded
  - Some inputs are hard coded to ten decimal places, which indicates the numbers come from some other program or spreadsheet calculation
  - Some numbers are from link to "OpEx Buildup", where the source numbers are in turn hard coded
- "2008 OpEx Comp"
  - Percentages in the column "% of Expense Outside of TSA" are hard coded, no source
  - Values in "08 Amount" (projected 2008 expenses) are derived via formula reference to cells in "OpEx Buildup" spreadsheet". The referenced cells contain data for which no source is ultimately available.

Q. DOES THE ESTIMATION OF CASH EXPENSES IN THE MODEL HAVE A VERIFIABLE SOURCE?

A. No, aside from **<u>***BEGIN HIGHLY CONFIDENTIAL***</u>** **<u>***END HIGHLY CONFIDENTIAL***</u>**. I determined this by **<u>***BEGIN HIGHLY CONFIDENTIAL***</u>** **<u>***END HIGHLY CONFIDENTIAL***</u>**. The results are depicted on Exhibit DB-HCL2-18.

In sum, **<u>***BEGIN HIGHLY CONFIDENTIAL***</u>** **<u>***END HIGHLY CONFIDENTIAL***</u>**. This means that **<u>***BEGIN HIGHLY CONFIDENTIAL***</u>** **<u>***END HIGHLY CONFIDENTIAL***</u>**.

To illustrate this concretely for the Commission, I attach to this testimony as Exhibit DB-HCL2-19 **<u>***BEGIN HIGHLY CONFIDENTIAL***</u>** **<u>***END HIGHLY CONFIDENTIAL***</u>** from FairPoint's financial model. It should be noted that that **<u>***BEGIN HIGHLY CONFIDENTIAL***</u>** **<u>***END HIGHLY CONFIDENTIAL***</u>**.

Q. ARE THERE "DEAD" OR UNUSED CELLS AND INFORMATION IN THE MODEL?

Q. Yes. For example, **<u>***BEGIN HIGHLY CONFIDENTIAL***</u>**

<u>*END HIGHLY CONFIDENTIAL***</u>**.

Q. PLEASE SUMMARIZE FAIRPOINT'S PROJECTIONS AND ASSUMPTIONS REGARDING REVENUES.

A. FairPoint projects the revenue streams from both FairPoint's and Verizon's three state region to be almost completely flat.[169] For its existing territories, FairPoint

> assumed continued access line losses in its existing properties …[and] expected that increased bundling would drive higher penetration in non-regulated local products such as voicemail, call waiting and caller ID and that local revenue would remain relatively flat or decline slightly through the projection period. The cumulative effect of these assumptions is that total revenues were expected to decline between 0.4% and 1.2% every year of the projection period.[170]

For the "SpinCo" three state region, FairPoint made assumptions regarding: Switched Access Line customer trends, Broadband customer trends, Long Distance customer trends, Consumer Revenue, Small Business Revenue, Enterprise revenue, Partner Solutions revenue, Fiduciary revenue, Public revenue, LiveSource revenue, Internet Service provider revenue, Long Distance revenue, and MVNO revenue.[171]

Q. PLEASE ADDRESS FAIRPOINT'S ASSUMPTIONS REGARDING CUSTOMER VOLUMES AND REVENUES.

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[169] See Exhibit DB-P-8, FairPoint Amendment No. 5 to S-4, page 76.

A. The projections evidently assume no change in local rates. In general, where the switched access line losses are assumed to be "mitigated" by FairPoint, this is contrary to industry trends, and is also contrary to the fact that competition from cable telephony in the three states has been muted by Adelphia's business and legal issues. In this regard, the projections are probably too optimistic.

In addition, the projections **<u>***BEGIN HIGHLY CONFIDENTIAL***</u>**

<u>END HIGHLY CONFIDENTIAL***</u>**. This also is contrary to the fact that competition from cable telephony in the three states has been muted by Adelphia's business and legal issues.

Furthermore, the broadband projections appear to assume that DSL customer additions happen quicker rather than slower, and thus would not recognize any significant difficulties that FairPoint may encounter due to poor plant conditions and needed plant upgrades. The fact that service quality problems have been significant in the three states over past years is indicative that DSL take-up by consumers will not necessarily be able to occur promptly and on a broad scale. In addition, poor service quality may lead to additional line loss.

[170] Id., page 75.

The Commission should consider **<u>***BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION***</u>** **<u>***END HIGHLY CONFIDENTIAL HSR INFORMATION***</u>** with the inroads earned by cable telephony. In addition, it appears that FairPoint makes an assumption that is **<u>***BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION***</u>** **<u>***END HIGHLY CONFIDENTIAL HSR INFORMATION***</u>**, regarding long distance penetration rates.[172] **<u>***BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION***</u>** **<u>***END HIGHLY CONFIDENTIAL HSR INFORMATION***</u>**.[173] Although, the effect of this is probably minimal. Also, there are a number of assumptions where average revenue per unit (ARPU) is optimistically assumed to be flat

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[171] See Exhibit DB-P-8, FairPoint Amendment No. 5 to S-4, at pages 79-81.
[172] See Exhibit DB-HCL2-13, Verizon HSR Attachment 4(c)-7, <u>*****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****</u>
<u>*****END HIGHLY CONFIDENTIAL HSR INFORMATION*****</u>
[173] Exhibit DB-HCL2-13, Verizon HSR Attachment 4(c)-7, <u>*****BEGIN HIGHLY CONFIDENTIAL HSR INFORMATION*****</u>
<u>*****END HIGHLY CONFIDENTIAL HSR INFORMATION*****</u>

or increasing in light of competition from cable modem and telephony, and from Verizon.[174]

Q. PLEASE ELABORATE ON YOUR CAUTION REGARDING THE RATE OF DSL TAKE-UP.

A. First, very recent information makes clear that FairPoint does not have the information it needs from Verizon in order to formulate its "DSL Plan." The OCA understands from conversations with counsel for FairPoint, and with our counterparts in Maine, that FairPoint will revise its DSL Plan in the near future.

Further light on this circumstance is shed by several FairPoint responses to data requests, as follows:

1. NH Staff GII 2-35, which sought broadband deployment plans: **<u>***BEGIN HIGHLY CONFIDENTIAL***</u>**

<u>*END HIGHLY CONFIDENTIAL***</u>;**[175] and

[174] See Exhibit DB-P-8, FairPoint Amendment No. 5 to S-4, at pages 79-81.
[175] See Exhibit DB-HCL1-2, FairPoint's reply to Staff GII 2-35.

2. OCA FDR II-34: "FairPoint does not take the position that there is no need for network improvement or staffing changes, nor does FairPoint take the position that change in either is required."[176]

Clearly, FairPoint **<u>***BEGIN HIGHLY CONFIDENTIAL***</u>**

<u>*END HIGHLY CONFIDENTIAL***</u>**.

It follows **<u>***BEGIN HIGHLY CONFIDENTIAL***</u>**

<u>*END HIGHLY CONFIDENTIAL***</u>**. FairPoint's projected financial modeling **<u>***BEGIN HIGHLY CONFIDENTIAL***</u>**

<u>*END HIGHLY CONFIDENTIAL***</u>**. To the extent that this assumption is not valid, the financial projections must be **<u>***BEGIN HIGHLY CONFIDENTIAL***</u>**

<u>*END HIGHLY CONFIDENTIAL***</u>**.

[176] See Exhibit DB-P-27, FairPoint's reply to OCA FDR II-34.

Q. DOES FAIRPOINT HAVE SIGNIFICANT PREVIOUS EXPERIENCE IN THE PROVISION OF UNBUNDLED NETWORK ELEMENTS (UNES)?

A. No. This may explain at least in part some of the UNE projections which I consider to be problematic on their face. Specifically, FairPoint projects that business UNE-P and UNE-L's generally will <u>*****BEGIN HIGHLY CONFIDENTIAL*****</u>

<u>*****END HIGHLY CONFIDENTIAL*****</u> Nationwide, ILECs report the following UNE-L volumes, from which growth rates can be calculated as indicated.

	ILEC UNE-L (Thousands)	
Jun-03	4227	
Jun-04	4322	2.25%
Jun-05	4300	-0.51%
Jun-06	4413	2.63%

Source: FCC Local Competition Report, Table 4

Similarly, UNE-P volumes and growth rates are shown as follows:

	ILEC UNE-P (Thousands)	
Jun-03	13,036	
Jun-04	17,136	31.45%
Jun-05	14,596	-14.82%
Jun-06	8,443	-42.16%

Source: FCC Local Competition Report, Table 4

Q. PLEASE ADDRESS THE FAIRPOINT PROJECTIONS OF LONG TERM LIABILITIES AND SHAREHOLDER'S EQUITY.

A. Long term liabilities from 2007-2015 have a flat trend, $2,590 million in 2007, and $2,549 in 2015.[177] FairPoint essentially does not gain at all on its long term liabilities over the course of this period. Shareholders equity declines almost $900 million dollars over the same period, to a <u>negative</u> $218 million in 2015.

Q. IS THIS THE EQUITY BALANCE THAT IS CONTAINED IN FAIRPOINT'S MODEL?

[177] See Exhibit DB-P-8, FairPoint Amendment No. 5 to S-4, at page 78.

A. No. The FairPoint model contains the following balances for Shareholders Equity:

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<u>*END HIGHLY CONFIDENTIAL***</u>**

Q. IS NEGATIVE SHAREHOLDERS EQUITY APPROPRIATE FROM A PUBLIC POLICY PERSPECTIVE?

A. No. Equity balances have accumulated over time from the provision of services to local ratepayers. These equity balances should not be eliminated without a purpose which is valid and useful to local ratepayers. The Commission should not consider it to be a valid purpose in the public interest to <u>*****BEGIN HIGHLY CONFIDENTIAL*****</u>

<u>*END HIGHLY CONFIDENTIAL***</u>**. This is particularly the case when <u>*****BEGIN HIGHLY CONFIDENTIAL INFORMATION*****</u>

<u>*END HIGHLY</u>**

CONFIDENTIAL***.

Q. DOES THE MODEL ADDRESS CHANGES IN THE ECONOMY?

A. No. I do not consider this to necessarily be a flaw, as economic downturns are inherently difficult or impossible to predict. However, this is an additional concern that the Commission should have, since FairPoint's projected results would be impacted negatively from a business downturn.

C. Model and Cash Flows

Q. WHERE WAS YOUR ULTIMATE FOCUS IN YOUR REVIEW OF THE MODEL?

A. Beyond the assumptions, data and mathematical formulas, my ultimate focus was on "free cash flow", which I view as cash available after payment of dividends and all other cash obligations. This focus aligns with recent FairPoint statements that

> Cash Flow is the Key: Regardless of the debt and equity composition of any purchase, the key factor is whether the combined company after the merger has enough cash flow to cover its obligations. This is where opponents miss the point. We expect the combined company to generate cash flow greater than the amount necessary to cover planned network investment, operating expenses, all debt service and dividends to stockholders.[178]

Cash flow is essential, since it is cash that pays expenses, taxes, capital expenditures, interest and dividends.

[178] Exhibit DB-P-29, FairPoint Communications, Form 425, filed June 21, 2007, Annex 1, at page 2.

Q. DID YOU FOCUS ON REVISING THE MODEL INPUTS TO ADDRESS EACH CONCERN THAT YOU HAVE IDENTIFIED OR NOTED IN YOUR REVIEW OF THE MODEL?

A. No. I did not focus on attempting to revise or redo assumptions and data generally to produce an "alternative model". Instead I focused on revising a few areas I consider to be most material for the Commission's review in this matter: capital expenditures, operating expenses, interest rates, and UNE assumptions.

Q. WHAT FIGURES AND ASSUMPTIONS APPEAR TO BE THE MOST MATERIAL IN TERMS OF AFFECTING THE MODEL RESULTS OF PROJECTIONS OF FREE CASH FLOW?

A. Model projected results for free cash flow would be most materially affected by the following:

- Assumed growth/decline rates for subscriber volumes and revenues;
- Cash expenses (which exclude depreciation), of which the largest component is labor;
- Capital expenditures;
- Interest on debt; and
- Dividends.

Q. WHAT CASH FLOW ESTIMATIONS HAS FAIRPOINT PRODUCED IN THIS CASE?

A. The primary cash flow estimations upon which FairPoint relies in this case are the cash flow estimations in Mr. Leach's testimony,[179] and the cash flow estimations contained in the model. I will emphasize cash flow projections from the model, and other sources such as internal investment advisor projections, to the extent available. The projected revenues and net increase/(decrease) to cash balances are as follows:

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<u>*****END HIGHLY CONFIDENTIAL*****</u>

Q. ARE THE OPERATING EXPENSE ESTIMATIONS INCORPORATED IN THE MODEL LIKELY TO BE SUFFICIENTLY ACCURATE IN YOUR VIEW?

A. No. FairPoint's S-4A indicates that "FairPoint assumed that expenses in the Spinco business would remain relatively flat or increase slightly over the projection period." This is in absolute terms, so that costs per line would be slightly increasing under this assumption. This is contrary to the operating expense pattern shown in recent actual FairPoint data in SEC reports[180]:

[179] See Direct Testimony of Walter Leach on behalf of FairPoint, at page 31.
[180] Exhibit DB-P-18, FairPoint Form 10-K, March 14, 2006, at page 41.

		2003	2004	2005	2006	
FairPoint						
Operating Expenses		$ 111,203	$ 128,804	$ 143,425	$ 155,463	
Access Lines						
	Residence	196,145	189,668	188,206	194,119	
	Business	50,226	49,606	55,410	57,587	
	Total	246,371	239,274	243,616	251,706	
		$ 451.36	$ 538.31	$ 588.73	$ 617.64	Average
	Y over Y		19.26%	9.37%	4.91%	11.18%

Operating expense per line from FairPoint's financial model is as follows:

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According to FairPoint's SEC data, operating expenses have increased an average of 11% over the past three years, on a per line basis. I used this information, and calculated adjusted operating expenses, assuming a less than average annual operating expense growth per access line of 9%. The results are shown below:

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I then substituted this revised operating expense projection into the model (extended to 2015), and the following impact on net increase/decrease to cash results:

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<u>*END HIGHLY CONFIDENTIAL***</u>**

Q. PLEASE SHOW THE EFFECT ON CASH FLOWS IF CAPITAL EXPENDITURES ***BEGIN HIGHLY CONFIDENTIAL*** ***END HIGHLY CONFIDENTIAL*** **THAN PROJECTED BY FAIRPOINT IN ITS MODELING, AS DISCUSSED EARLIER.**

A. The following adjusted cash flows are derived by simply increasing the capital expenditures line item in the financial model by 10%:

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*****END HIGHLY CONFIDENTIAL *****

Q. WHAT IS THE RESULT ON NET CASH FLOW IF THE UNE LOOP GROWTH RATE IS REDUCED TO A MORE REASONABLE LEVEL, REFLECTING VERIZON'S EXPERIENCED GROWTH PATTERNS?

A. The following results from reducing the UNE-Loop growth rate from that which FairPoint assumed in the model, to what recent experience of Verizon's, which ***<u>**BEGIN HIGHLY CONFIDENTIAL*****</u>

<u>*****END HIGHLY CONFIDENTIAL*****</u>

Q. WHAT IS THE RESULT IF HIGHER OPERATING EXPENSES, HIGHER INTEREST RATES, LOWER UNE GROWTH, AND HIGHER CAPITAL EXPENDITURES OCCUR AT THE SAME TIME?

A. These are the results:

<u>*BEGIN HIGHLY CONFIDENTIAL***</u>**

	2008	2009	2010	2011	2012

<u>*END HIGHLY CONFIDENTIAL***</u>**

Q. ARE YOU SUGGESTING TO THE COMMISSION THAT THESE RESULTS WILL HAPPEN IF IT APPROVES THE PROPOSED TRANSACTION?

A. No. No one can say what <u>will</u> happen. However, this does illustrate the severe impact on a highly leveraged entity from unfavorable changes in operating expenses, interest rates, unforeseen capital expenditures, and inaccurate projection of UNE growth. Given FairPoint's historical operating expense patterns, model projected operating expenses are probably too low, therefore the increased operating expenses I have used above are reasonably possible. There is prospect of substantial change in financial markets, since risk margin levels on borrow are at historical lows. Therefore, it is reasonable to expect that FairPoint's borrowing costs will be higher than depicted in the model. FairPoint has not been able to conduct detailed evaluation of plant and plant records, and will not know the actual condition of the physical plant until after the transaction closed . It is reasonable to expect that further capital expenditures will be required beyond what is included in the model, given the base figures from which FairPoint projected capital expenditures, and the recurring service quality problems experienced in the three state area.

D. Conclusions

Q. WHAT ARE YOUR GENERAL CONCLUSIONS REGARDING THE USABILITY OF THE MODEL BY THE COMMISSION IN THIS PROCEEDING?

A. The model and the projected results presented by FairPoint are not sufficiently reliable for the Commission to use it in determining whether the proposed transaction results in a financially viable public utility. For all its apparent complexity, there is much less to the model results than meets the eye, given underlying assumptions, data and modeling concerns. While I was able to make some changes to show sensitivities, as above, there are a number of difficulties with the model that make it unreliable as an ultimate demonstration of financial viability of the combined entity to the Commission. A large amount of data within the model is “hard coded” via either broken formulas or links, or derivation of data from other processes that are not included. It is impossible for the analyst to trace and verify data sources and assumptions in many areas. Data cannot easily be modified in some cases in order to flow through changes from different assumptions, which in combination with the other model problems essentially prevents the Commission from modifying the model data and assumptions to “clean it up” for its own use. Some assumptions are inherently inconsistent. As discussed above, some assumptions fail to consider the impact of competition from the cable companies, and are otherwise overly optimistic. The Commission should not place any reliance on

FairPoint's projected financial results as demonstration of financial viability of the proposed combined company.

VI. FairPoint Transparency in Regulatory Process

Q. DO YOU BELIEVE FAIRPOINT HAS BEEN TRANSPARENT IN THIS PROCEEDING WITH REGARD TO PROVIDING REQUESTED INFORMATION, AND CLAIMS OF CONFIDENTIALITY?

A. As a general matter, I do not believe FairPoint has been transparent and forthcoming in the production of information in this case. FairPoint has made iterative filings of SEC documents that have made public information that FairPoint had previously claimed as "confidential." FairPoint has also made public statements in other forums which divulge information that FairPoint had previously claimed as confidential. Except one instance following the filing of the July 2 S-4A, FairPoint has not subsequently notified the parties or the Commission of its removal of a claim of confidentiality. Furthermore, FairPoint disclosed certain information publicly before the SEC which OCA had sought, but FairPoint objected to providing, including investment advisor reports.[181]

Other examples include:

- The Deutsche Bank Fairness opinion provided confidentially in response to OCA GI-1-14, but disclosed publicly as an attachment to FairPoint's Form S-4A;

[181] FairPoint Amendment No. 4 to S-4A, Annexes C-1 and C-2.

- $44 million cost of the “DSL Build out Plan” was claimed confidential by FairPoint, but then it disclosed the figure in public forums;
- The Leach Direct Testimony is excessively redacted, such that beginning at page 21 and ending at page 36, the text is redacted in its entirety with claim of “Confidential Information”. While aspects of the information on those pages can legitimately be claimed as “confidential”, the redaction of 15 entire pages is entirely too broad-scale. Necessary confidentiality could have been preserved with much less invasive redaction. Much of the text could remain in the public view, with figures and perhaps some directionality (e.g., “increase” or “decrease”) redacted.

In addition, throughout the proceeding, FairPoint has not been forthcoming in production of documents, or admitting to existence of certain documents, which has made analysis of the proposal extremely difficult. For example:

- FairPoint objected to the provision of Hart/Scott/Rodino documents on the grounds of relevance, and provided them only when it became clear the companies would be compelled to provide the documents. I have found the HSR documents highly relevant, and have referred to them in this testimony.
- FairPoint objected to the provision of the financial model which was the core of the company’s financial case, and again only provided the model when it became clear that it would be compelled to provide it. Even then, FairPoint took extra time to “clean it up” before providing it. The model as provided contains references to

numerous external spreadsheets or data that were not provided with the model, so our ability to trace and understand source data, assumptions and calculations is blocked. In addition, much of the data within the model is "hard-coded" to 8, 13 or more decimal places to the right, such that it is evident that the data came from another source or process. Links to other data have been eliminated, or formulas have been eliminated, leaving only the values, which are generally not traceable to an external documented source.

- Cash flow analyses were requested in OCA GI 1-38, and FairPoint's only response was to refer to 19 pages of printout of financial model output. Very late in the discovery process, other cash flow analyses were provided by FairPoint when it provided the reports from its investment advisors .
- Copies of "any and all documents identifying synergies" were requested in OCA GI 1-31, and in FairPoint's initial replies only 19 pages of documents consisting essentially of summary print out from the financial model were provided. Much later, documents containing synergies estimates were attached to FairPoint's Form S-4A, and other existing documentation including spreadsheet calculations were provided to the OCA but only after other disclosures made clear that further synergies analysis existed.

Q. SHOULD THE COMMISSION TAKE THIS PATTERN OF NON-TRANSPARENCY AS AN INDICATOR OF FAIRPOINT'S "REGULATORY CITIZENSHIP" IF THE APPLICATION WAS APPROVED?

A. Yes. Based on FairPoint's actions in this case, the Commission should be concerned that FairPoint would not be forthcoming with information in the future if the Commission were to approve the proposed transaction. It is not consistent with the public interest for a public utility to make access to information difficult for the Commission.

VIII. Recommendations and Conclusions

Q. PLEASE SUMMARIZE YOUR RECOMMENDATIONS AND CONCLUSIONS TO THE COMMISSION IN THIS CASE.

A. Based on my testimony and analysis above, I recommend that the Commission deny the Verizon New England and FairPoint's Joint Application for approval to transfer the assets and franchise of Verizon New England in New Hampshire to FairPoint. If the Commission is not inclined to reject the Joint Petition, I recommend that the Commission require Verizon New England and FairPoint to take certain affirmative steps and provide certain additional information to the Commission before the Commission make its determination on the Joint Petition. I also recommend that if the Commission remains inclined to approve the Joint Petition after the Joint Applicants have undertaken these further steps and provided additional information, that the Commission impose numerous, strong requirements upon the Joint Applicants as conditions of approval. For further detail about my conclusions and recommendations, please see pages 8 through 14.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes. However, I reserve the right to file supplemental testimony to the extent that additional information becomes available.