STATE OF NEW HAMPSHIRE
PUBLIC UTILITIES COMMISSION

VERIZON NEW ENGLAND, INC. , et al)
)
)
RE: Request for Approval of Affiliated Interest)
Transaction and Transfer of Assets of Verizon's)
Property and Customer Relations to be Merged)
With and Into FairPoint Communications, Inc.)
)
Docket No. DT 07-011)

MAIN BRIEF
OF
COMMUNICATIONS WORKERS OF AMERICA
AND
INTERNATIONAL BROTHERHOOD OF ELECTRICAL WORKERS
(LABOR INTERVENORS)

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I. Introduction and Summary of Argument

A. Introduction

Verizon New England Inc. and its parent Verizon Communications Inc. (collectively "Verizon") are seeking permission to divest its landline and long distance telecommunications business in New Hampshire and the neighboring states of Vermont and Maine (collectively, "Northern New England" or "NNE"). In particular, Verizon proposes to spin off its NNE operations into a new, separate subsidiary (usually called "Spinco" in the filed documents).

Spinco would then be acquired (through a merger) by an existing, very small telecommunications holding company, FairPoint Communications Inc. (FairPoint), for approximately $2.7 billion in consideration. The consideration would be paid in a combination of cash (approximately $900 million), newly issued FairPoint bonds (approximately $800 million), and FairPoint common stock (54 million shares whose value fluctuates, but is estimated to be worth approximately $1 billion). FairPoint will need to borrow the entire $1.7 billion non-stock consideration that will be paid to Verizon.

Verizon would then exchange the approximately $800 million in FairPoint bonds for existing Verizon long-term debt, and transfer the FairPoint common stock to existing Verizon stockholders. As a result, current Verizon stockholders would end up owning approximately 60% of FairPoint's common stock.

The Communications Workers of America (CWA) and International Brotherhood of Electrical Workers (IBEW) (collectively, "Labor Intervenors") represent more than 70 percent of Verizon New England Inc.'s workforce in Northern New England (NNE), including Verizon New Hampshire. CWA and IBEW intervened in this proceeding, as well as the parallel proceedings in Vermont and Maine, to protect the interests of their members. Those interests include having an employer that has the financial resources, technical expertise, and corporate culture to provide high-quality service to customers, while ensuring the safety and reliability of its facilities.

B. The Fundamental Issue in This Case: Financial Fitness

At the outset, Labor Intervenors would highlight the fundamental reason why the New Hampshire Public Utilities Commission (Commission) must deny the application and reject the proposed transaction as being contrary to the public interest. Emerging from the voluminous record is one unequivocal fact: FairPoint is not financially fit. The Commission can use several factors to assess FairPoint's financial condition, all of which are undisputed:

- FairPoint will add $1.7 billion in debt.[1]
- In 2006, the debt-to-equity ratio was 0.59 for Verizon and 2.70 for FairPoint. However, it would have been 7.81 for the combined FairPoint-Verizon NNE operations.[2]
- FairPoint does not have, and does not foresee having, an investment-grade bond rating.[3]
- FairPoint has not yet obtained funding for nearly half of the purchase price it must pay to Verizon, and it does not have a commitment for that funding. FairPoint also cannot say what the interest rate will be on that debt, or what other terms and conditions might be required for that debt by the underwriters.[4]
- FairPoint's shareholder equity will steadily decline, go negative and then continue to decline by hundreds of millions of dollars – all within the next eight years.[5]

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[1] FairPoint Exh. 8P at 15.
[2] Labor Exh. 2P, Sch. RB-4.
[3] Tr. 10/23/07 at 33, 97, and 224.
[4] Tr. 10/23/07 at 110.
[5] FairPoint Exh. 8HC, Exh. WL-3 (section 1, p. 3 of 4)

- FairPoint's projected capital expenditures through 2015 are consistently $50 million to $60 million per year less than Verizon actually spent annually from 2002 through 2006. Much of that reduction in investment will be felt in New Hampshire, where FairPoint will be abandoning Verizon's fiber-to-the-home build-out (known as FiOS).[6]
- If the terms on FairPoint's new loans are the same as current restrictions then FairPoint would not be able to increase it annual capital expenditures by $50 million – and thus spend the same as Verizon had – because it would be in default of its loans.[7]
- FairPoint's outflow of resources to its shareholders is much higher than Verizon's. In 2006, Verizon's dividends amounted to 76% of its net income while FairPoint paid out 178%. FairPoint plans a cumulative dividend that is 279% greater than its net income through 2015. FairPoint would pay out $1.1 billion in dividends but only obtain $248 million in net income – a payout of $4 in dividends for every $1 in net income.[8]

If FairPoint is permitted to assume Verizon's role, it will result in (a) a cost of capital that is significantly higher than Verizon NNE's cost of capital, (b) a dramatic decline in the level of capital investment in New Hampshire, and (c) a significant risk of financial collapse.

C. Summary of Argument

Labor Intervenors discuss in Section II, below, that the Commission is required to determine whether the proposed transaction is "for the public good." The Commission has generally interpreted this standard to mean that the applicants must show that there will be "no

[6] Compare FairPoint S-4 filing, p. 16 (see Tr. 10/31/07 at 165-68) with Labor Exh. 2P, Sch. RB-11.
[7] Tr. 10/23/07 at 157.
[8] Labor Exh. 2P, Schs. RB-3 and RB-12.

net harm" to the public from the proposed transaction. There are also indications that the Commission will evaluate whether the proposed transaction produces a "net benefit" for consumers. The proposed transaction fails to meet either standard. New Hampshire will be significantly worse off if FairPoint is allowed to become the dominant telecommunications provider in the state.

In reaching that conclusion, Labor Intervenors focused their attention on two criteria that Labor Intervenors submit are the most important to assessing this transaction: (a) whether FairPoint will be financially fit and (b) whether FairPoint's proposed acquisition will result in service quality being adequate.

Labor Intervenors retained an independent financial consultant, Randy Barber, to provide an objective analysis of FairPoint's financial fitness to own and operate Verizon's NNE operations. As explained in Section III, below, Mr. Barber conducted an extensive financial analysis and concluded that FairPoint does not have the financial resources to provide safe and reliable service to New Hampshire's consumers. FairPoint's own financial projections show the company's financial condition worsening each year, with FairPoint continually paying out two to three times as much in dividends to stockholders as it actually earns on its operations. In effect, FairPoint projects that it will cannibalize Verizon New Hampshire – using all of the earnings (and much more) generated by the business to pay dividends to stockholders, instead of reinvesting in New Hampshire's telecommunications infrastructure. Indeed, FairPoint is projecting a significant decrease from Verizon's level of capital investment.

Mr. Barber also concluded that even that dire outcome is the result of FairPoint making extremely optimistic projections. None of those unfounded projections is more glaring than FairPoint's assumption that it will lose between 4 and 4.5 percent of its workforce each year beginning in 2009. That represents more than 140 people in the first year; more than 700 people within five years. In effect, within five years, FairPoint projects that it will have fewer employees than Verizon NNE has today – even though FairPoint is hiring at least 675 new people to provide network operations, call center, and other back office operations provided for Verizon NNE by Verizon affiliates in other states. But within five years, FairPoint assumes it will be able to provide extensive new network and customer service functions, maintain the physical network, and fulfill its myriad promises, with fewer people than Verizon NNE has today.

In Section IV, below, Labor Intervenors evaluate the impact of the proposed transaction on service quality. The testimony of Dr. Kenneth Peres, an economist in CWA's national office, demonstrates that FairPoint does not have a history that is consistent with providing high quality service to customers. Further, given Verizon's inability or unwillingness to meet minimum service quality standards (let alone provide the type of high quality service that consumers expect), FairPoint would need to focus on – and devote significant resources to – providing reliable service. But FairPoint's ability to achieve acceptable service quality performance will be impaired by a lack of adequate resources, the potential loss of experienced workers, and the significant risks posed by FairPoint's creation and implementation of dozens of new operational, support and administrative systems.

Given FairPoint's inability to meet these critically important standards of fitness, Labor Intervenors strongly recommend that the Commission reject the proposed transaction, as explained in Section V.A. FairPoint simply is not a qualified purchaser of Verizon's NNE operations, including Verizon New Hampshire. The deficiencies with FairPoint are too pervasive to be cured through the Commission's usual practice of imposing conditions.

Conditions cannot make FairPoint financially viable. Conditions cannot give FairPoint the resources necessary to provide reliable service to customers. Conditions cannot fully protect the public against the likely adverse consequences of allowing FairPoint to own and operate Verizon New Hampshire.

In the event that the Commission disagrees, however, Labor Intervenors recommend in Section V.B, below, that the Commission adopt several, stringent conditions. Labor Intervenors would emphasize that these conditions would not make this transaction beneficial to the public, or even ensure that the public is not harmed by the transaction. Rather, even the most stringent conditions would only be an attempt to insulate the public from some of the serious risks posed by the proposed transaction. In Labor Intervenors' judgment, taken as a whole the conditions would not result in a transaction that promotes the public good. They would only lead to a transaction that is less harmful to the public than the transaction that would exist if the application were granted as proposed by FairPoint and Verizon.

Chairman Getz appropriately summarized the difficult decision the Commission faces, when he stated:

> The proposed transaction before us is fundamentally different from the situation the Commission faces when a … larger company with more resources seeks to acquire a smaller company and it can be relatively assured that there are the financial, technical and managerial capabilities within that new entity to address any outstanding operating concerns or any other issues of risk.

Tr. 11/1/07 at 96-97.

FairPoint's fitness is the fundamental issue in this case and FairPoint fails to pass the test. Dr. Peres explained as follows that, because of FairPoint's lack of financial resources, the best way – indeed the only way – to protect the public from significant harm is to reject the proposed transaction. As he testified:

> If the transaction is denied in part due to the lack of resources available to FairPoint to address service quality and if Verizon still wanted to sell the lines – the company should be required to improve service quality before any subsequent sale of its New Hampshire lines. Further, the company must choose a buyer with the financial, technical and managerial resources needed to properly maintain and improve service quality.

Labor Exh. 1P at 35.

Similarly, Mr. Barber testified that any purchaser should meet four criteria: "adequate capitalization; adequate reserves; adequate infrastructure; and a demonstrated ability to absorb, integrate, and operate entities of comparable size and complexity to the entities the acquirer is proposing to acquire." Labor Exh. 2P at 59. FairPoint meets <u>none</u> of those standards. <u>Id.</u> Indeed, as Mr. Barber states: "FairPoint fails on every reasonable measure of a competent successor to Verizon New Hampshire." <u>Id.</u>

Labor Intervenors conclude, therefore, that the best way, indeed the only way, for the Commission to protect the public is to reject the proposed transaction. FairPoint does not have the resources or expertise to step into Verizon's shoes. There is no set of conditions that would make this transaction consistent with the public interest or ensure that the public will not suffer significant harm.

II. Legal Standards

The Joint Application filed by FairPoint and Verizon requests approval under three provisions of the law: RSA 374:26, RSA 374:28, and RSA 374:30. Joint Application pp. 3-4.

RSA 374:26 requires Commission approval before a utility can enter into business in the state or change its existing service area. In making such a determination, the statute requires the Commission to find that such an action "would be for the public good." The statute also permits the Commission to "prescribe such terms and conditions for the exercise of the privilege granted … as it shall consider for the public interest."

RSA 374:28 authorizes the Commission to permit a utility to discontinue service to the public. This statute also requires the Commission to apply a "public good" standard. Thus, the statute states that the Commission can authorize the permanent discontinuance of service "whenever it shall appear that the public good does not require the further continuance of such service."

RSA 374:30 governs the transfer of a utility's "franchise, works or system" or any part thereof. Here again, the law requires the Commission to approve such a transfer only if it finds "that it will be for the public good."

The Commission has held that, in evaluating the "for the public good" standard, it has "a longstanding practice of evaluating the managerial, financial, and technical ability of the proposed transferee to operate a public utility." See, e.g., *Hampstead Area Water Company, Inc.*, Order No. 24,803, 2007 N.H. PUC LEXIS 79 (Nov. 2, 2007); *Rosebrook Water Company, MWH Preservation Limited Partnership and BW Land Holdings, LLC*, Order No. 24,773, 2007 N.H. PUC LEXIS 51 (July 12, 2007).

The Commission also has generally ruled that the "for the public good" standard is a "no net harm" standard that only requires a showing that the public will not be harmed by the proposed transaction. See *Aquarion Water Company of New Hampshire*, Order No. 24,691, 2006 N.H. PUC LEXIS 127 (Oct. 31, 2006) ("In light of these statutory requirements, the Commission has evaluated the assertions of petitioners that there are no adverse effects, and no net harm, associated with the transaction."), citing *Hampton Water Works, Inc.*, 87 NH PUC 104 (2002) and *Eastern Utilities Associates,* 76 NH PUC 236 (1991).

There are indications, however, that the Commission may apply a more stringent "net benefit" standard to such transactions. For example, in *Merrimack County Telephone Co.*, Order

No. 23,961, 87 NH PUC 278, 2002 N.H. PUC LEXIS 45 (May 1, 2002), the Commission stated: "In verifying the assertion made by the Parties at the hearing that there are no adverse effects, or no net harm associated with the transaction, we also inquired as to whether the acquisition provides net benefits to consumers." See also *National Grid plc*, Order No. 24,777, 259 P.U.R.4th 226, 2007 N.H. PUC LEXIS 55 (July 12, 2007).

As Labor Intervenors discuss in the remainder of this brief, FairPoint fails to meet either a "no net harm" standard or a "net benefit" standard. FairPoint will be much weaker financially than Verizon. and it will not be able to raise capital or obtain credit on reasonable terms. FairPoint will spend $50 million to $60 million less on capital expenditures each year than Verizon actually spent in 2006. Within five years, FairPoint projects that its workforce will be smaller than Verizon's NNE workforce is today – even though FairPoint has to hire at least 675 new people to perform functions currently performed by Verizon in states outside NNE. Further, FairPoint's weaker financial condition, lower capital expenditures and reduced workforce levels will impair its ability to provide safe and reliable service as well as build out broadband. Labor Intervenors submit that the public will be harmed by this transaction. There are no conditions that can adequately remedy these harms. Consequently, the Commission must reject the proposed transaction.

III. FairPoint Will Not Be Financially Viable

A. Introduction

FairPoint prepared financial projections for the NNE operations through the year 2015. Even if all of FairPoint's assumptions were accepted, those projections show that FairPoint would not be financially viable if this transaction is approved. Rather, as Labor Intervenors explain in Section III.B., those projections show a company that will be financially stressed and at serious risk of being unable to pay its common stock dividend, refinance its multi-billion dollar debt, meet its obligations to employees, and make the necessary investments in network maintenance and improvements.

Just as troubling is the fact that FairPoint's operating expense assumptions are seriously flawed. In Section III.C., Labor Intervenors discuss the grossly optimistic nature of FairPoint's expense assumptions. When those assumptions are made more realistic, it shows that FairPoint would be in financial distress within just a few years. Moreover that disastrous result would occur even if all of FairPoint's other assumptions – including its optimistic assumptions about revenues, DSL customers, reduced capital expenditure requirements, and more – are accepted.

In Section III.D., Labor Intervenors show that the financial analyses of other witnesses do not affect these conclusions. None of those witnesses could justify FairPoint's exceedingly optimistic assumptions about operating expense levels, including employee attrition. And none of them produced a financial analysis that results in FairPoint being a viable company with a bond rating that even approaches investment grade.

As a consequence, the Commission must reject the proposed application, as explained in Section III.E. FairPoint is not a financially viable purchaser of Verizon's NNE operations, including Verizon New Hampshire. There is no set of conditions that would make FairPoint financially viable. While the Commission could adopt conditions designed to protect consumers from some of the adverse consequences of financial failure, adopting such conditions would not make this transaction consistent with the public good. Rather, such conditions only would be an attempt to protect the public from some of the detrimental effects of FairPoint being allowed to own and operate Verizon New Hampshire.

B. FairPoint's Financial Projections Are Not Consistent with a Company that is Financially Viable

Even if the Commission were to accept all of FairPoint's assumptions (which the Commission certainly should not do, as explained in Section III.C, below), FairPoint's financial projections do not reflect a company that is financially fit. Labor Intervenors' financial expert, Randy Barber[9], carefully reviewed FairPoint's history and method of doing business and found a pattern that is troubling, to say the least.

Mr. Barber's testimony shows that FairPoint is an excessively risky holding company that cannibalizes its operating companies to pay an unsustainable dividend. It must continue to acquire new properties to keep ahead of its dividend and debt service needs.

Mr. Barber's extensive testimony contains detailed analyses to support his conclusions. Rather than repeating all of that detail here, Labor Intervenors will focus on Mr. Barber's conclusions, which are fully supported by his testimony. Importantly, Mr. Barber concluded:

> FairPoint is a very risky holding company, specializing in acquiring, operating, and selling telecommunications companies. Fundamental to its financial strategy is the utilization of "free cash flow," derived primarily from depreciation, to pay very high dividends. In 2006, FairPoint's dividends were 76% higher than its net income and its dividends were roughly equal to its depreciation and amortization. …
>
> FairPoint is cannibalizing itself by continually paying out more in dividends than it earns. It generates the cash to do this from depreciation – taking money that should be reinvested in its networks and, instead, paying it out to stockholders as a dividend. In its short life as a public company, FairPoint's shareholder equity has declined by $57 million, or 21.4%, even though its net income was $60 million for the same period. That is, in the last two years, FairPoint has paid dividends equal to nearly twice its level of net income.

[9] Mr. Barber has more than 25 years of experience as a financial analyst and occasional expert witness. His clients tend to be labor unions, and public and private pension funds. He has analyzed numerous transactions in several industries, including airlines, telecommunications, education, among others. Mr. Barber knows what it means for a company to be in financial distress, having worked on several bankruptcy proceedings, as well the divestiture of numerous Lucent Technologies lines of business. Labor Exh. 2P at 2-3. Mr. Barber's analyses of FairPoint can be found in his public direct testimony (Labor Exh. 2P) and highly confidential direct testimony (Labor Exh. 3HC).

> I call this cannibalization because FairPoint is quite literally eating itself alive. FairPoint's strategy is extremely risky and can continue for only so long. In order to sustain FairPoint's approach to business, it must continually acquire new companies and use the depreciation-based cash flows from those new companies to provide the cash to support its high payments.
>
> In other words, FairPoint's approach to business is to invest as little as possible in capital plant and siphon the rest of the cash out of the operating companies to support its extraordinarily high dividend payment. It is clear to me that FairPoint's business model relies on the acquisition of companies with depreciable assets that can be used to support FairPoint's dividend payments, some amount of debt retirement, and acquisition of additional properties (with additional depreciable assets). <u>With a business model such as this, it is imperative to restrain capital expenditures</u>, since they compete with dividend payments, debt reduction and additional acquisitions, particularly when dividend payments are first among equals in the competition for corporate resources. <u>It is not sustainable to continually pay out more in dividends than the company earns in net income.</u>
>
> While it touts its investment and operational plans, FairPoint's strategy is really keyed to generating cash flow then using that cash to pay interest on its debt and dividends to stockholders. <u>If its projections prove to be over-optimistic and its results materially suffer, FairPoint will need to adjust by squeezing its employees' compensation, raising prices, permitting service to deteriorate, reducing investment, cutting dividends, or, more likely, a combination of these. The impact of such actions is likely to be devastating to New Hampshire.</u>

Labor Exh. 2P at 6-7 (emphasis added).

Several of these points are worth emphasizing. FairPoint continually pays out far more in dividends than it earns in net income. For the past two years, FairPoint's level of dividend payments has been between 122% and 178% of net income. Labor Exh. 2P, Sch. RB-9. This is not sustainable and will soon result in FairPoint having negative shareholders' equity; that is, FairPoint's debt will exceed the book value of its assets.

Incredibly, FairPoint projects that this trend will be accelerated if it is allowed to purchase Verizon NNE. FairPoint projects that its dividend payments from 2009 through 2015 will range between 200% and 300% of net income. <u>Id.</u>, Schs. RB-11 and RB-12. The result is that its shareholders' equity will become negative by 2010 and will decline by hundreds of millions of dollars thereafter. FairPoint Exh. 9HC, Exh. WL-3 (section 1, p. 3 of 4).

Mr. Barber used the term "cannibalization" to describe FairPoint's business model: the company is quite literally eating itself alive – extracting cash for stockholders well in excess of the equity those stockholders have invested in the firm and well in excess of the net income the business can earn. This led Mr. Barber to question whether FairPoint even would be able to call its payments to stockholders dividends and treat them as such for tax purposes. Labor Exh. 3C at 15-16. Mr. Barber's testimony on this point is based on counsel's legal analysis. Briefly, Section 170 of Delaware corporation law prohibits corporations from paying dividends that exceed the greater of the value of retained earnings or the net profit earned in the current year or the previous year.[10] 8 Del. C. § 170. Similarly, Sections 301 and 316 of the Internal Revenue Code limit the favorable income tax treatment for dividends to payments that are made from a corporation's accumulated net income. Payments in excess of that amount are treated as returns of capital which are taxed as capital gains. 26 U.S.C. §§ 301 and 316.

Simply, once FairPoint's retained earnings go negative (which under FairPoint's projection is in 2010), FairPoint legally would not be able to pay dividends in excess of its current year's net income. But that doesn't stop FairPoint. It projects that even after shareholders' equity becomes negative, it will continue to make payments to its stockholders that are at least twice as high as its level of net income. From 2010 through 2015, these excess payments total hundreds of millions of dollars. FairPoint Exh. 8C, Exh. WL-1. Those payments are not dividends; they represent FairPoint going deeper into debt, failing to reinvest in its NNE

[10] FairPoint is a Delaware corporation. FairPoint S-4 filing, opening letter. (The Commission took administrative notice of the contents of the S-4 filing. Tr. 10/25/07 at 8.) Interestingly, later in that S.E.C. filing, FairPoint recognizes this same concern, stating: "The combined company may not generate sufficient cash from continuing operations in the future, or have sufficient surplus or net profits under Delaware law, to pay dividends on its common stock in accordance with the dividend policy." Id., p. 35 (emphasis added).

operations, or failing to reduce its outstanding debt – all to fulfill its corporate goal of enriching its stockholders.

Why is all this so troubling? It is troubling because the need in New Hampshire, Maine, and Vermont is great, but FairPoint's commitment is paltry. Rather than reduce its dividend payments to a level that can be supported by its earnings, FairPoint proposes to pay nearly all of its free cash flow to its stockholders. After the first year, its projected level of capital investment in NNE is substantially less than Verizon's current level of investment. Specifically, in 2006, Verizon NNE's capital expenditures were $214 million. FairPoint S-4 filing, p. 16. During the past five years, Verizon NNE's capital expenditures have ranged between $182 million and $228 million. Id., and Tr. 10/31/07 at 165. In contrast, FairPoint is projecting capital expenditures from 2009 through 2015 of only $156 million to $167 million per year. Labor Exh. 2P, Sch. RB-11. FairPoint will spend $50 million to $60 million less on capital expenditures each year than Verizon actually spent in 2006. That money would leave Northern New England and flow to FairPoint's stockholders.

Instead of making excessive payments to stockholders, FairPoint could enhance service in NNE. But it has chosen not to. After the first year, FairPoint is projecting that its operating expenses and workforce levels will decline precipitously. Instead of making excessive payments to stockholders, FairPoint could make a strong commitment to NNE's economy and its quality of service by keeping its workforce at reasonable levels. But it has chosen not to.

The old saying is that if you want to see what's important to someone, don't listen to what they say, watch where they spend their money. FairPoint is spending its money on its stockholders – not on improving service to customers; not on capital expenditures; not on its workforce; and not on community development.

Because of the extraordinary debt burden being undertaken by FairPoint for this transaction, it is unclear whether FairPoint would be able to significantly increase capital expenditures without being in default on its loans. FairPoint's commitment letter includes a restriction on the level of capital expenditures as a percentage of earnings. Labor Exh. 4C. The percentage has not been established yet, but it is expected to be similar to (perhaps somewhat higher than) the existing loan agreement's restriction of 37.5% of adjusted EBITDA. Tr. 10/23/07 at 82. If that is the case, then FairPoint would be unable to increase capital expenditures even to the level that Verizon actually spent from 2002 through 2006. Tr. 10/23/07 at 157.

FairPoint also will reduce its workforce by between 100 and 150 people per year, "saving" tens of millions of dollars each year. Tr. 10/23/07 at 215; Tr. 10/29/07 at 234. That money is leaving Northern New England and flowing to FairPoint's stockholders.

It could be argued that all of this might be acceptable so long as the utility is financially sound and stable. But that is not the case with FairPoint. FairPoint does not have an investment-grade bond rating and it does not have any prospects for obtaining, or desire to obtain, such a rating in the future. Tr. 10/23/07 at 33, 97, and 224. Indeed, with shareholders' equity continuing to decline and dividend payments greatly in excess of earnings, it is difficult to see how FairPoint could ever obtain an investment-grade rating (unless, of course, it radically changed its priorities – which it has given no indication of doing).

An investment-grade bond rating is not the only way for a utility to demonstrate its financial soundness and stability. A company could have a history of stable financial performance. Its financial metrics could show steady improvement. Reasonable assumptions could lead to projections of improved financial performance. But FairPoint has none of these.

FairPoint came into existence in 1991. FairPoint S-4, p. 11. By 2002, it had lost hundreds of millions of dollars – resulting in shareholders' equity of negative $146 million. Id., p. 18. FairPoint continued to lose money in 2003 and 2004, so that by year-end 2004 shareholders' equity was negative $173 million. Id. In February 2005, FairPoint restructured financially, including an initial public offering (IPO) of common stock. Tr. 10/23/07 at 22. The IPO and restructuring resulted in FairPoint restoring shareholders' equity to $267 million at March 31, 2005. Labor Exh. 2P, Sch. RB-8. But, once again, FairPoint's old ways intervened and it continued to pay out substantially more in dividends than it earned. Just ten months after the IPO (year-end 2005), FairPoint already had seen its shareholders' equity decline by $17 million. Id. And by March 31, 2007, FairPoint's shareholders' equity had declined by tens of millions of dollars to less than $210 million. Id. FairPoint is not a company with a history of stable financial performance.

Similarly, FairPoint's history is not consistent with a company that can improve its financial performance over time. In 2002, FairPoint lost $8 million on its continuing operations, before income taxes. FairPoint S-4, p. 17. It lost another $8 million in 2003, and the loss ballooned to $24 million in 2004. Id. As noted above, 2005 was a restructuring year that involved retiring debt and preferred stock and replacing much of it with common stock. In 2006, FairPoint showed positive income before taxes, but that was largely because it reduced its debt (resulting in lower interest expense) and substituted high-yield common stock. Thus, while FairPoint showed net income from continuing operations of $50 million in 2006, its shareholders' equity continued to decline because its dividend payments exceeded even its pre-tax net income by millions of dollars. Labor Exh. 2P, Sch. RB-9. FairPoint is not a company that has shown an ability to steadily improve its financial performance.

Finally, as discussed above, FairPoint's financial projections do not show stable financial performance going forward. FairPoint's projections – as optimistic as they are – show that the company's net income will increase slightly (but the increase is solely because of a decline in depreciation and amortization expense, due to FairPoint's under-investment in new plant). Labor Exh. 2P, Sch. RB-11. FairPoint projects that its dividend payments will continue to greatly exceed its earnings. Id. The company projects that its capital expenditures will decline each year. Id. FairPoint projects that its shareholders' equity will steadily decline, go negative, and then continue to decline by hundreds of millions of dollars – all within the next eight years. FairPoint Exh. 9HC, Exh. WL-3 (section 1, p. 3 of 4). FairPoint is not a company that shows a reasonable likelihood of improved, or even stable, financial performance.

Based on his review of FairPoint's financial projections, history, and business model, Mr. Barber concluded that it would not serve the public good to permit FairPoint to consummate the proposed transaction. As Mr. Barber testified:

> FairPoint is simply too small, too inexperienced, and too thinly capitalized to undertake a venture of this magnitude. FairPoint's lack of experience with an operation of the size and scope of Verizon NNE, FairPoint's business model based on siphoning cash out of operating companies to support one of the highest dividend payments in the industry, FairPoint's high operating costs, FairPoint's sharply declining level of shareholder equity, and FairPoint's lack of financial cushion all point to the same, inescapable conclusion: FairPoint does not have the financial capability to reliably undertake this transaction, without posing extraordinary risks to New Hampshire's consumers, work force, and economy. The Commission should refuse to allow FairPoint and Verizon to jeopardize New Hampshire's future.

Labor Exh. 2P at 53 (emphasis added).

In short, even under FairPoint's very optimistic projections, FairPoint is not financially fit to become the dominant telecommunications provider in New Hampshire.

C. FairPoint's Operating Expense Assumptions are Fundamentally Flawed. If Those Assumptions are Made More Realistic, FairPoint Would be in Financial Distress.

FairPoint's projections for its operating expenses are seriously flawed, and those flaws are of such a magnitude that they call into question FairPoint's very financial solvency. That is, even if the Commission accepts every other assumption FairPoint makes, correcting FairPoint's operating expense assumptions would be sufficient to find that FairPoint cannot be financially sound and stable.

Any analysis of FairPoint's operating expense projections should begin with a review of FairPoint's historic ability to predict and control operating expenses. Mr. Barber conducted such a review and found that FairPoint had not exhibited an ability either to accurately predict its operating expenses or to control the rate of growth in those expenses.

In April 2004, FairPoint prepared a projection of its operating expenses for the years 2005 and 2006. FairPoint projected that its operating expenses over that 20-month period would increase by 5.9%. In fact, FairPoint's expenses actually increased at nearly twice that rate, or by 10.7%. Labor Exh. 3HC at 22 and Sch. RB-22.[11]

A miss of that magnitude – and over such a short period of time – certainly calls into question FairPoint's ability to project its operating expenses at all, let alone for an eight-year period.

Next, it would be reasonable to evaluate how well FairPoint and Verizon NNE have been able to control the growth in operating expenses over the past few years. After all, it's FairPoint's management and Verizon's operating personnel who will manage the growth in operating expenses going forward.

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[11] FairPoint's simultaneous projection of operating revenues was just as inaccurate, resulting in FairPoint missing its projected net income level by almost 20%. Labor Exh. 3HC at 22 and Sch. RB-22.

Mr. Barber conducted that analysis and found that both FairPoint and Verizon NNE have experienced operating expense increases of about 5% or more per year. Specifically, over the five-year period from 2002 through 2006, FairPoint's operating expenses increased by 32% ($51 million), even though its number of access lines increased by only about 4% (10,000 lines). Labor Exh. 2P, Sch. RB-6. The result is that FairPoint's operating expense per access line increased by more than 27% over this five-year period.

Mr. Barber's analysis of similar data for Verizon NNE shows that the number of access lines declined by 18%, but operating expenses still increased by more than 6% during this time period. On a per-line basis, the results are similar to FairPoint's: an increase of 30% over the five-year period. Id.

In other words, both FairPoint and Verizon have a similar operating experience during the past five years: operating expenses per line are increasing at roughly 5% per year.

Inexplicably, FairPoint is projecting that its operating expenses per line, from 2009 through 2015, will be essentially flat, even after its assumed 8% to 12% reduction in operating expenses from "synergies." Labor Exh. 3HC, Sch. RB-21. That is, despite FairPoint and Verizon NNE both experiencing growth in the range of 5% or more per year for the past five years, FairPoint somehow has assumed that it will magically turn this around, and operating expense growth will cease. Apparently, neither inflation, wage increases, supplier cost increases, nor any other factors will affect FairPoint between 2009 and 2015.

Further, on an overall basis, FairPoint has projected that its operating expenses will increase by less than 1% per year, and actually decrease in some years. FairPoint Exh. 9HC, Exh. WL-3; Labor Exh. 2P, Sch. RB-11; Labor Exh. 3HC, Sch. RB-21. In fact, overall FairPoint projects that its cash operating expenses[12] will decline by 2% from 2009 through 2015. Tr. 10/23/07 at 194-95; Labor Exh. 11HC.

Incredibly, these projections are supposed to include the impact of eight years worth of inflation, wage increases, and other cost increases. Tr. 10/23/07 at 195.

This bears repeating: FairPoint projects that its actual, out of pocket cash expenses will be 2% lower in 2015 than they will be in 2009. Such a projection is simply not credible on its face.

Commission Staff witness Antonuk reached the same conclusion about FairPoint's operating expense projections. Specifically, he testified:

> Those are built into FairPoint's assumptions about its costs. We think those assumptions are counterintuitive. You can't accept on faith that a company that, I think was pointed out, is about maybe one or less percent the size of Verizon is going to come in and save that kind of money. We haven't looked at Verizon for a while. We did a management audit of Verizon. We did an affiliates audit. We looked at these organizations in the early to mid 1990s. We found some things that we thought could be improved. But you know what else we found? We found that they, like any other company their size we've looked at, run a fairly efficient ship, do a fairly good job at supporting people. And, I certainly haven't heard Verizon -- anybody from Verizon stand up and say "we waste money in New Hampshire." I haven't heard them stand up and say "we don't pursue revenue opportunities in New Hampshire." And, I don't think they will. And, if they did, I don't think I'd believe them. But I'm certainly not going to believe anyone else coming in and saying "we simply are going to count on the existence on knocking $70 million of real costs out of this business that we aren't going to have to -- we're not going to have to replace, because, ultimately, however it's termed, what FairPoint is saying, they can be more efficient than Verizon. There's no away to get around that when you're done with this.

Tr. 10/25/07 at 78-80 (emphasis added).

FairPoint's expense projections would be laughable if the consequences were not so serious. And that seriousness is apparent when the details behind FairPoint's incredible projection are examined.

[12] Operating expenses less depreciation and amortization, less the non-cash portion of pension and OPEB expense.

One of the fundamental flaws in FairPoint's projection is its assumption that it will lose between 4 and 4.5 percent of its workforce each year through attrition. Tr. 10/23/07 at 215. With a starting workforce level of approximately 3,500 people (Tr. 10/29/07 at 234), FairPoint is effectively projecting the loss of between 140 and 155 people in 2009, with similar losses in each year following. Thus, <u>within five years FairPoint projects that its workforce will be smaller than Verizon's NNE workforce is today</u>, even though FairPoint has to hire at least 675 new people to perform functions currently performed by Verizon in states outside NNE. In effect, the equivalent of those 675 new employees would be gone within five years. Once again, such an assumption is simply not credible.

But the impact of just that employee attrition assumption is enormous – amounting to tens of millions of dollars per year (particularly in the later years of FairPoint's projection). See Tr. 10/23/07 at 186. Changing that assumption – and nothing else – would be sufficient to fundamentally change FairPoint's financial outlook. The magnitude of the change (the precise number is claimed by FairPoint to be confidential) would exceed FairPoint's projected net income in the later years, and would greatly exceed FairPoint's projected free cash flow after dividends in those years. Compare Tr. 10/23/07 at 186 with FairPoint Exh. 9HC, Exh. WL-3 (section 1, p. 4 of 4).

FairPoint attempts to justify its attrition assumption based on the level of attrition that Verizon NNE actually experienced during 2006. Tr. 10/23/07 at 179. But such a comparison is flawed for at least two reasons.

First, there is no showing that what Verizon NNE experienced in one year will be replicated – or is even sustainable – over a seven- or eight-year period.

Second, it must be recalled that Verizon NNE is essentially just an operating utility. If FairPoint takes over the operation, it projects that it will add 675 new employees to perform functions that Verizon currently performs in states outside of NNE. These functions include network operations; various call center, customer service, and operator service functions; billing; administration; and many others. There has been no showing that Verizon experiences anywhere near the same level of attrition in those functions that it experiences within the NNE operation itself.

Thus, there is no basis for assuming that the attrition level that Verizon experienced in one year would provide a reasonable basis for FairPoint's assumption for the better part of a decade. Indeed, it would be hard to imagine that FairPoint would be able to provide even marginally acceptable service with a workforce that would shrink by roughly 900 people (a loss of about one in every four employees) in just seven or eight years.

But that is the leap of faith that is required in order to accept FairPoint's financial projections. One must assume that a company that has experienced 5% annual growth in expenses will acquire another company that has experienced 5% annual growth in expenses – and that magically we will have a company that experiences no growth in expenses. FairPoint will accomplish this miracle, apparently, by greatly reducing the size of its workforce. But don't worry, FairPoint assures us, it will be able to do much more with less – it will provide enhanced service to customers, a more reliable network, increased access to broadband services, and so much more. All with fewer people, lower expenses, and more efficiency than one of the largest telecommunications companies in the world.[13]

Were people's livelihoods not on the line, it would be a good joke. Were the future of New Hampshire's economy not in jeopardy, we would laugh out loud. It sounds like a good old-

[13] As shown in the next section, FairPoint's projections are not made reasonable by assuming a loss of access lines.

fashioned snake oil salesman, or what we learned in law school was called "dealer's puffing" – you can't rely on the promises made by a salesman when he touts his product because everyone knows he's just trying to make himself and his product look good.[14]

But this is no joke, we're not buying a used car, and the consequences of a mistake are dire. In fact, FairPoint itself has characterized a downturn in cash flow on the order of $67 million as being a "materially adverse condition" or "worst case" under which FairPoint's Board of Directors might abandon the transaction. Labor Exh. 2P at 47. <u>This is of the same order of magnitude as the impact of FairPoint's attrition assumption in 2015.</u> Tr. 9/6/07 at 13-20. In other words, even FairPoint recognizes that it cannot be financially solvent unless it reduces its workforce by more than 100 people each and every year.

In summary, FairPoint's operating expense assumptions – and particularly its employee attrition assumption – are seriously flawed and undercut its entire financial model. If a reasonable level of expense increases over time, and a reasonable workforce level, were used, it would demonstrate unequivocally that FairPoint would be in serious financial distress. FairPoint simply does not have the financial capability to own and operate Verizon NNE.

D. The Analyses of FairPoint Witnesses Balhoff and King Do Not Alter These Conclusions

FairPoint hired two witnesses, Messrs. Balhoff and King, to review various aspects of FairPoint's projections. Both witnesses found that FairPoint's overall numbers were consistent with industry trends and similar to other medium-sized telephone operating companies. In both cases, though, the witnesses failed to review in detail FairPoint's assumptions for operating expenses, particularly the assumed loss of hundreds of employees. Both witnesses

[14] See generally 77 C.J.S. Sales § 310c ("Under the established and governing rules, dealer's talk is permissible; and puffing, or praise of the goods by the seller, is no warranty, such representations falling within the maxim *simplex commendatio non obligat*.")

acknowledged that they had not reviewed the workforce or attrition assumptions. Tr. 10/24/07 at 21 and 62 (King) and 83 (Balhoff).

Interestingly, though, while Mr. King did not present any comparative analysis of workforce levels, his exhibits provide the information to conduct such an analysis. Those data (FairPoint Exh. 10HC, Exh. WEK-1, Table 1.1) show that Mr. King's "guideline" companies have a ratio of access lines to employees of between 208 (Consolidated Communications) and 405 (Windstream), with most companies falling in the middle of that range. Indeed, even the largest telecommunications companies in the country, Verizon and AT&T, only try to serve on the order of 200 access lines per employee.[15]

Yet FairPoint's projections for NNE start with it trying to serve far more access lines per employee than any of these other companies. Mr. King opined that FairPoint's ratio was in line with its peers, with between 385 and 403 lines per employee. Mr. King's subsequently provided workpaper (FairPoint Exh. 49C), however, shows that he used a starting number of employees greatly in excess of the 3,500 employees that FairPoint's President, Mr. Nixon, said FairPoint would have. Tr. 10/29/07 at 234.

Moreover, that ratio would only get worse under FairPoint's assumptions. From 2009 through 2015, FairPoint projects that it will lose employees at a higher rate than it will lose access lines. Compare FairPoint's workforce reduction of 4 to 4.5% per year with FairPoint Exh. 9HC, Exh. WL-3 (section 2, p. 1 of 10 (annual percent change in access line equivalents)).

Moreover, Mr. King's analysis of data for comparably sized companies from the years 2004 through 2006, plus the first quarter of 2007, does not support the reasonableness of FairPoint's operating expense assumptions. In fact, Mr. King's analysis shows that FairPoint's

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[15] All of these figures are calculated from Table 1.1 by dividing the number of access lines (times 1,000) by the number of employees. All figures are as of December 31, 2006.

operating expense assumptions (per line or per connection) for 2009 through 2015 are lower than its peers actually experienced between 2004 and early 2007. Further, his comparison does not adjust the industry numbers for inflation, wage increases, energy prices, materials costs, or any other factors. Tr. 10/24/07 at 20-21.

Thus, rather than showing the reasonableness of FairPoint's projections, Mr. King's analysis actually shows that FairPoint is projecting operating expenses per line or per connection for 2009 through 2015 that are lower than its peers actually experienced historically. When coupled with FairPoint's projection that it will operate with far fewer employees per access line than other telecommunications companies, Mr. King's data and analysis actually reinforce Mr. Barber's finding that FairPoint's operating expense projections are unreasonable and incredibly optimistic.

E. Conclusion

FairPoint is financing the transition entirely with high-yield debt and high-yield common stock. The resulting interest and dividend payments not only leave little margin for error, they do not even leave enough room for reasonable operating assumptions. FairPoint's financial model is based on one fiction after another: FairPoint will be able to provide improved service while slashing the workforce by hundreds of people; FairPoint will be immune to inflation and so will be able to control expenses to an unprecedented level; FairPoint will be able to improve service and enhance broadband availability while spending $50 million to $60 million less per year on capital expenditures than Verizon has during the past five years.

There is no basis for such wishful thinking. In reality, FairPoint will be severely stressed financially. FairPoint's expenses will be higher than it projects; its earnings will be lower; its level of capital expenditures will need to be higher (but FairPoint's debt covenants may restrict its ability to actually increase capital expenditures to the level required).

Based on these facts, the Commission must conclude that FairPoint is not financially fit to own and operate Verizon NNE, including Verizon New Hampshire.

IV. There is a Substantial Risk that FairPoint's Service Quality and Customer Service Will Not Be Adequate

A. Introduction

Service quality for Verizon New Hampshire's landline customers today is below acceptable levels. If FairPoint is permitted to own Verizon New Hampshire, it will put service quality in New Hampshire at additional risk. If the transaction is approved, FairPoint's ability to achieve acceptable service quality performance will be impaired by a lack of adequate resources, the potential loss of experienced workers, and the significant risks posed by FairPoint's creation and implementation of dozens of new operational, support and administrative systems. See Sections IV.B. and IV.C.

In fact, as discussed in Section IV.D., FairPoint itself has demonstrated the risks associated with the transition through its past poor performance, including problems its customers experienced when it attempted to develop new systems and run "new" businesses.

In Section IV.E., Labor Intervenors show that FairPoint's own track record in Maine and Vermont does not provide a basis for concluding FairPoint has a corporate commitment to high quality service.

As explained in Section IV.F., even if FairPoint were to promise the Commission that it will bring service quality in the Verizon territory up to acceptable levels, in reality FairPoint will have fewer resources to improve service quality than Verizon and, therefore consumers will be in a worse position if the transaction is approved.

Based on FairPoint's history of mediocre service quality performance, as well as its severely constrained financial resources, the Commission must conclude that FairPoint will not be able to provide adequate and reliable service to New Hampshire consumers. The Commission, therefore, should reject the transaction. See Section IV.G.

If the Commission disagrees, however, Labor Intervenors provide a list of service quality conditions in Section IV.H. These conditions would help to protect consumers from the adverse consequences of FairPoint ownership of Verizon New Hampshire, but they would not completely alleviate the harm to the public that would be caused if the transaction is approved.

B. If this Transaction is Approved, FairPoint Will Have to Expend Resources to Correct Service Quality Deficits Created by Verizon

If Verizon is allowed to transfer its landlines in New Hampshire to FairPoint, FairPoint will have to correct problems left behind by Verizon, in addition to fulfilling ongoing responsibilities to maintain service quality and customer service. Verizon has allowed service quality to deteriorate over the last several years. Only additional infusions of capital and personnel will permit FairPoint to remedy the service quality deficiencies accrued under Verizon's recent stewardship.

Dr. Kenneth Peres[16] showed that, from 2001 to 2006, Verizon experienced a 277% increase in residential complaints per 1 million access lines, a 56% increase in average installation intervals, a 78% increase in average out-of-service repair intervals, and a 29% increase in repeat out-of-service trouble reports as a percentage of initial out-of-service reports. Labor Exh. 1P at 19. Complaints per one million lines in New Hampshire went from 159 in 2001 to 600 in 2006. Id. Similarly, average installation intervals in days lengthened from 0.9 days in 2001 to 1.4 days in 2006. Id. The out-of-service repair interval lengthened from 19.9

[16] Dr. Peres is an economist in the national office of CWA. Among his other areas of expertise, he has testified on telephone utility service quality issues before several state utility commissions and the Federal Communications Commission. Labor Exh. 1P at 1-2. Dr. Peres's analysis of Verizon's and FairPoint's service quality can be found in his direct testimony (Labor Exh. 1P).

hours in 2001 to 35.4 hours in 2006. Finally, repeat troubles as a percent of initial out of service troubles increased from 13.3% in 2001 to 17.1% in 2006. Id.

Dr. Peres' observations that Verizon service quality has deteriorated in recent years are consistent with data gathered by this Commission. Based on this data, Dr. Peres showed that from 2001 to 2006, Verizon experienced a 28% increase in the percentage of residential out-of-service conditions not cleared within 24 hours, an 89% increase in average repair completion time, a 31% increase in the trouble report rate, and a 32% increase in the number of orders held for more than 30 days. Id. at 20.

Similarly, Susan Baldwin, testifying on behalf of the Office of Consumer Advocate, described a number of service quality deficiencies, as well as problems with Verizon customer service performance in recent years. After an extensive review of Verizon's service quality data, she concludes: "the quality of basic local exchange service in New Hampshire has been deteriorating for several years." OCA Exh. 2P at 57. Importantly, she found that this appeared to be the result of business decisions made by Verizon, and not some unavoidable condition. Thus, she testified: "Verizon NH service quality metrics generally improved during the period 1996 to 2000. As demonstrated by the metrics recorded after 2000, however, it is clear that Verizon NH has let customer service and quality of service deteriorate in recent years." Id. at 70. Ms. Baldwin then explained how this affected the proposed transaction:

> Verizon NH's service quality is indisputably in decline. As a result, simply allowing FairPoint to maintain "business as usual" isn't good enough. The deteriorating service quality is compelling evidence of the absence of any real internal incentive (such as executive compensation being linked to service quality) or external incentive (such as either market discipline or regulatory consequences) to improve and maintain service quality. In the absence of competition and in the wake of this serious decline in service quality, I urge the Commission to establish adequate financial incentives – and to seek legislative authority if necessary – for FairPoint to improve and maintain service quality. The

> Commission should not rely upon vague statements regarding FairPoint's more local focus to ensure improvements in service quality.

Id. at 73-74 (emphasis added).

Verizon witness Nestor testified that he did not take issue with the data used by Dr. Peres and Ms. Baldwin. Tr. 10/31/07 at 162-63 (Peres data) and 185 (Baldwin data). He did suggest, though, that the Commission should use a broader view of service quality and conclude that "the overall service quality that Verizon NH has provided and continues to provide to its customers is very good." Verizon Exh. 3C at 3. Yet Mr. Nestor also acknowledges that Verizon has failed to meet three of the ten benchmark standards during the past 30 months. Id. at 9. He also acknowledges that many of the areas where Verizon's service is deteriorating are "more rural and have a relatively small number of access lines." Id. at 10. In other words, Verizon apparently has allowed service quality to decline in less urban portions of New Hampshire.

Mr. Nestor then claims that what's really important is customers' overall assessment of the service they are receiving. But a review of the data he relies on shows that more than 20% of residential consumers are dissatisfied with their repair service. Id. at 13. This is remarkable because Verizon experiences a high volume of repair calls. As Mr. Nestor testified, on average Verizon receives one repair call each year for every five lines it has in service. Tr. 10/31/07 at 159-60.

FairPoint will be further challenged to succeed in bringing service quality up to adequate levels, because Verizon has also left service quality inadequately supported in the other two Northern New England states FairPoint proposes to acquire. These deficiencies will add to the cost of labor and capital investment needed to reverse Verizon's trends in recent years. Dr. Peres testified that Verizon Vermont experienced similar dramatic declines in service quality from

2001 to 2006. Labor Exh. 1P at 21-22. Similarly, a recent report by a hearing examiner with the Maine Public Utilities Commission (PUC) stated:

> [A] review of Verizon's service quality results during the current AFOR [Alternative Form of Regulation in effect since 2001] reveals that service quality has declined. ...Last year and this year, the performance [in a key metric] is even worse.

Investigation into New Alternative Form of Regulation for Verizon Maine Pursuant to 35-A M.R.S.A., §§ 9102-9103, Examiner's Report (Revenue Requirement and Service Quality Issues), May 9, 2007, Maine Public Utilities Commission, Docket No. 2005-155, p. 247, quoted in Labor Exh. 1P at 25-26.

In response to the degradation of service quality in Maine, the hearing examiner recommended tightening the service quality index, and increasing penalties. Labor Exh. 1P at 26. Again, the problem cannot be fixed by replacing Verizon with a firm that is not capable of fixing the deficiencies left by Verizon.

The service quality risks occasioned by the shakiness of FairPoint's financial situation are compounded by FairPoint's lack of comprehensive knowledge of the state of Verizon's plant. See, e.g., Tr. 10/29/07 at 44, 47, 88, and 93. If significant portions of Verizon's infrastructure in New Hampshire require upgrades beyond those assumed in FairPoint's financial planning, the pressure on FairPoint's ability to meet its investment requirements will increase. The result is a further risk that service quality will not be brought up to standards, and a likelihood that it will not improve.

Verizon should not be rewarded for ignoring its obligations in Northern New England by allowing it to hand off its system "as is" to another entity, at a substantial profit, regardless of that entity's ability to spend what it takes to ensure high quality service. The Commission must satisfy itself that the prospective owner and operator of landline service for the vast majority of

New Hampshire residents is capable of, and likely to, bring service quality in the Verizon service territory in all measured areas up to minimum standards, and to maintain it at required levels.[17]

C. In Addition to Limited Financial Resources, FairPoint's Ability to Bring Service Quality to Acceptable Levels Will Be Challenged by the Potential Loss of Significant Numbers of Experienced Workers.

In order to address these service quality problems (as well as other needs), FairPoint will need an experienced field workforce. There is a significant risk, however, that if the proposed transaction is approved, Northern New England will face a mass exodus of experienced Verizon workers. Labor Exh. 1P at 29-31 and Tr. 10/31/07 at 206-211. As Dr. Peres states, Verizon relies on its most experienced workers to train new employees. If many experienced workers leave, it affects not only day-to-day operations but also training of less experienced workers. Labor Exh. 1P at 30. Thus, he notes that it "takes 42 months for a new technician to be considered fully trained and able to work independently. This time period may well last longer in FairPoint's case since the experienced mentors that make on-the-job training a reality may no longer exist in sufficient numbers." Id. at 30-31. As Dr. Peres stated: "The loss of experienced workers is very critical. … You can imagine the loss of workers with 25, 30 years' experience in sizable numbers will have a major, major impact on operations and the delivery of service quality to the consumer." Tr. 10/31/07 at 210.

Already, Verizon employees are seeking assignments and transfers to Verizon's operations in Massachusetts or other states. Conversely, employees in other states no longer bid on jobs in Maine, New Hampshire and Vermont, which previously obtained many such bids. Labor Exh. 1P at 29-30. This anecdotal evidence of employees "voting with their feet" on the proposed transaction does not indicate confidence of the workforce in the prospective new

[17] Bringing superior quality to service in New Hampshire would, *a fortiori*, require more resources than needed to bring service quality up to minimally acceptable levels.

Northern New England ownership. Union officials also have received numerous reports from employees of their intentions to resign if the takeover is approved. Id.

To determine the reliability of these reports, Dr. Peres prepared and supervised a survey of the potentially affected employees. Under his direction, the CWA and IBEW distributed the survey to union-represented employees in the three states. Tr. 10/31/07 at 206-07 and OCA Exh. 126P.

The survey was divided between pension-eligible employees and non-pension-eligible employees. Both groups were asked similar questions. The first question asked whether the surveyed employees were seriously considering leaving the company if the proposed transaction is approved and they would become employees of FairPoint. The second question asked these same workers whether they would seriously consider leaving the company if the transaction is not approved and they would remain employees of Verizon. Tr. 10/31/07 at 207-08.

The responses to the survey confirm the anecdotal evidence of worker distrust of FairPoint, and the likely loss of significant portions of the current workforce if the transaction is approved. Fifty-six percent of all the employees returning the survey stated that they would seriously consider leaving the company if the transaction were approved. However, only 7% said they would seriously consider leaving the company if the transaction were not approved. Id. at 208.

The survey also illustrates the significant risk of a mass exodus of pension-eligible employees in the three-state region if the transaction is approved. Eighty percent of the pension-eligible employees who returned the survey stated that they will seriously consider retirement if the transaction is approved. Id. at 208.

Looking specifically at responses of Verizon employees in New Hampshire, 352 New Hampshire employees (34% of the union-represented workforce) responded to the survey. OCA Exh. 126P. Fifty-two (52%) percent of the New Hampshire respondents stated that they would seriously consider leaving their current employment if the transaction were approved, but only 5% said they would seriously consider leaving if the transaction were not approved. Id. Thus, 48% of the New Hampshire respondents stated that they are seriously considering leaving their current employment solely because of a FairPoint take-over. Id.

Extending these survey results to the entire union-represented workforce in New Hampshire indicates that almost 500 Verizon New Hampshire employees are seriously considering leaving the company if the transaction is approved. Id. and Tr. 10/31/07 at 209.

Dr. Peres acknowledged that the survey does not prove that the indicated numbers of employees will definitely leave their positions if the transaction is approved. Tr. 10/31/07 at 209. The magnitude of the response, however, indicates that this is a potentially serious problem that FairPoint must plan for, yet such plans are not in place. Tr. 10/29/07 at 130-31.

In summary, there are strong indications that FairPoint's ability to provide reliable service, address long-standing deferred maintenance issues, and implement its broadband deployment plans may be jeopardized by the loss of hundreds of experienced employees. FairPoint has not convinced Verizon employees that FairPoint would be a stable, long-term employer that would provide reasonable compensation, benefits, and working conditions. Moreover, it does not appear that FairPoint considers this to be a serious risk, so it has not yet developed plans to deal with the potential loss of a significant percentage of Verizon's skilled workforce.

D. FairPoint Has Not Demonstrated a Commitment to Consistently High Quality Service in Vermont or Maine.

FairPoint's subsidiaries in Maine and Vermont have experienced several service quality problems that do not bode well for FairPoint's ability to assume Verizon New Hampshire's operations.

In Maine, FairPoint's subsidiaries have "among the highest customer trouble report rates" in the state. Labor Exh. 1P at 11. Dr. Peres summarized FairPoint's performance in Maine, as follows:

> For example, China Telephone, a FairPoint subsidiary, had the worst trouble report rate of the 23 companies reporting to the PUC in 2005, 2006 and the first quarter of 2007. The performance of its Northland subsidiary has gotten relatively worse over time: it had the eighth worst customer trouble report rate in 2005, the seventh worst in 2006 and the sixth worst rate in the first quarter of 2007.

Id. Further, in 2005 and 2006, "FairPoint subsidiaries account for the three worst customer complaint rates in the state." Id. at 12.

Similarly, FairPoint's Vermont subsidiary experienced a customer complaint rate more than five times higher than Verizon's (2.4 complaints per 1,000 access lines, compared to Verizon's rate of 0.46). Id. at 15. Indeed, "in six of the last seven years, FairPoint had the highest rate of customer complaints" in Vermont. Id. at 15-16.

E. FairPoint's Own Track Record of Cutovers and New Business Ventures Does Not Bode Well for Successful Development of the Dozens of New Systems Needed to Provide Quality Service, Nor for Successful Transition from Verizon.

To accomplish the proposed transaction, FairPoint must simultaneously acquire or develop, test, implement, maintain, and manage dozens of systems and processes which provide the functionality currently performed by over 600 Verizon operational, support and administrative systems. Labor Exh. 1P at 14-15. But FairPoint has had difficulties managing the transfer of a much smaller set of functions, with resulting adverse impacts on customer service.

FairPoint has been in the process of centralizing and outsourcing its billing and related customer care operations for its operating subsidiaries. Id. at 13. In late 2005 the contractor that performed these outsourcing functions decided to sell its underlying software and would not add any more customers to its service bureau platform. Id. By this time, FairPoint had already converted 17 of its then 28 operating subsidiaries to the outsourced system. Id. Ultimately, FairPoint transferred this project to another firm. Id. This disruption in the effort to outsource development of billing and related customer care software led to the service, disconnection notice, and billing problems experienced by FairPoint's Maine customers. Id.

FairPoint's experience in Maine provides an example of the types of problems that could arise when FairPoint attempts to develop and integrate new operational, support and administrative systems for numerous functions, including some it has never performed before (such as wholesale provisioning). FairPoint's management has not demonstrated its ability to succeed at a systems transfer of the magnitude that would be required if this transaction is approved.

The experience and financial resources of a prospective successor to Verizon are crucial to a successful transfer. This reality was borne out when Verizon sold its Hawaii landlines to a Carlyle Group subsidiary, Hawaiian Telcom, in 2005. Labor Exh. 2P at 42-43. Hawaiian Telcom experienced significant problems with its cutover, despite having in place a transition services agreement similar to that between FairPoint and CapGemini in this case. Id. Hawaiian Telcom spent $100 million on new operations systems to handle the functions that previously were conducted by Verizon. The company experienced many problems with its new billing systems. The company hired an additional 120 employees. But the customer service problems still persisted. Id.

As of November 2006, according to Moody's Investor Services, Hawaiian Telcom had not managed to develop the systems it needs to function as a stand-alone business, and a "continuing delay in creating fully functioning back office systems [in turn] is contributing to numerous operational problems (i.e., customer care, order management, billing, and financial reporting) and distracting senior management." Id. at 43. See also, *In the Matter of the Application of Paradise Mergersub, Ind., GTE Corporation, Verizon Hawaii Inc., Bell Atlantic Communications Inc. and Verizon Select Services, Inc. for Approval of a Merger Transaction and Related Matters,* 2005 Haw. PUC LEXIS 125 (HI PUC March 16, 2005). Ultimately, Hawaiian Telcom replaced its information technology and related services consultant. Labor Exh. 2P at 43.

As Mr. Barber notes, the experience of Hawaiian Telcom and its transition services agreement (TSA) should act as a cautionary tale for regulators examining the proposed Verizon-FairPoint transaction. Id. at 43-44. There are important similarities between the two transactions. In both transactions, Verizon is selling its local exchange operations to a highly leveraged firm that lacks experience with an operation of this magnitude; the purchasers need to develop and integrate new operating and support systems; and each of the purchasers entered into a TSA with Verizon to smooth the transition process. Id. However, a crucial difference between the two situations is that the Carlyle Group had major financial resources it could extend to Hawaiian Telcom if it so desired. FairPoint will not have access to such resources. Id. at 44. If anything, FairPoint's ability to manage the transition without experiencing the problems Hawaii has faced will be constrained.

While there are always transitional challenges when telephone company operations are transferred to an experienced company's existing systems, that transaction can occur smoothly, as witnessed by the Verizon sale of its landline operations in Kentucky to Alltel, and the sale of its Alabama and Missouri landline operations to CenturyTel. Id. at 44. Alltel and CenturyTel were largely able to integrate Verizon's operations into their own existing systems and operations centers. Id. That will not be the case here. The proposed deal with FairPoint is so large that FairPoint cannot integrate NNE into existing FairPoint systems. Id. Instead, FairPoint will have to develop dozens of complex systems and operations from scratch in order to attempt to run the NNE operations. Id. FairPoint will be hard pressed to accomplish a cutover from Verizon's systems and operations without its customers facing potentially major disruptions to service quality and customer service.

In short, there is nothing in the experience of FairPoint that even approaches the magnitude of what it is attempting to do here. FairPoint had problems handling the conversion of its billing system. Now it is attempting to not only convert Verizon's billing system, but to simultaneously convert hundreds of other functions to dozens of new operational and support systems. The only other time such a task was attempted on this scale was in Hawaii where the results were disastrous. While FairPoint and Verizon claim that they will learn from the mistakes in Hawaii, that's a far cry from providing assurances that FairPoint will have the capabilities to convert to these new systems, let alone train thousands of people on their use[18] while simultaneously trying to run a multi-state telecommunications network. At the risk of understatement, it is fair to say that the potential for service quality problems is high, and the assurances provided by FairPoint are non-existent.

[18] Mr. Nixon acknowledged that essentially all of the 3,500 employees in NNE would need to be retrained. Tr. 10/29/07 at 239-40.

F. FairPoint's Constrained Financial Situation Will Undermine its Ability to Achieve and Maintain High Quality Service Levels.

Any Verizon successor will have to expend more than Verizon has in recent years on labor and capital investments, just to bring the system up to minimum standards. By rights, Verizon should be making this investment. However, that is not how this proposed deal is structured. The burden will fall to FairPoint. But FairPoint will not have the financial resources to bring service quality in Verizon's territory up to minimal standards, much less improve it.

As Mr. Barber shows in his testimony, FairPoint will face very difficult challenges simply finding the resources to properly operate and maintain the NNE properties as they are today, much less investing sufficient resources to improve Verizon's recent (and insufficient) performance:

> If its projections prove to be over-optimistic and its results materially suffer, FairPoint will need to adjust by squeezing its employees' compensation, raising prices, permitting service to deteriorate, reducing investment, cutting dividends, or, more likely, a combination of these. The impact of such actions is likely to be devastating to New Hampshire.

Labor Exh. 2P at 7.

According to Mr. Barber's analysis, there are a number of entirely credible scenarios that would result in a financial crisis for FairPoint. Such a crisis would require FairPoint to make some very hard decisions, each of which could have their own negative ramifications. They would all revolve around insufficient cash to fund all of the promises that FairPoint has made to its customers, employees, communities, regulators, shareholders, and lenders. Id. at 45.

As discussed above, FairPoint is likely to have to increase spending above Verizon's recent trends in order to make up for Verizon's neglect, and resulting service quality problems. But, as discussed in Section III.C., above, FairPoint's operating expense projection is woefully inadequate.

Other state commissions have expressed concern with FairPoint's ability to provide adequate service while maintaining its financial integrity. Labor Exh. 1P at 16-17. In 2005, FairPoint acquired the Berkshire Telephone Company in New York. The New York Public Service Commission (NY PSC) was so concerned about FairPoint's "relatively weak financial position" that it felt compelled to impose a significant number of conditions on its approval of the company's acquisition of Berkshire Telephone Company. Labor Exh. 10P. These conditions were imposed to protect the new subsidiary's financial health, capital investment, service quality and consumer rates. The conditions included the following:

- a service quality plan with the suspension of dividend payments and the imposition of customer rebates for substandard service;
- cost savings to flow to consumers;
- limits on dividend payments equivalent to the difference between EBITDA (earnings before interest, taxes, depreciation and amortization) and 100% of depreciation expenses in order to ensure adequate capital investment;
- limitations on dividend payments, debt and inter-affiliate transactions in order to limit the ability of FairPoint to use Berkshire as a cash cow.

Dr. Peres points out that the NY PSC imposed these conditions in the context of a small transaction ($20.3 million and 7,200 access line equivalents) with dramatically smaller attendant risks than the instant proposal – both to FairPoint and the business it was acquiring. Labor Exh. 1P at 17.

In short, as discussed in detail in Section III, above, FairPoint's financial constraints are likely to seriously affect the company's ability to provide reliable service to its customers. These impacts could be felt both during the transition and in the future as FairPoint's financial condition continues to deteriorate.

G. Because of FairPoint's Inability to Show that it Will Meet the Service Quality and Customer Service Standards Required for Approval, the Commission Should Reject the Proposed Transaction.

As Dr. Peres testified, the best way to protect consumers from the serious risks of the proposed transaction would be for the Commission to deny it. Labor Exh. 1P at 35-36. FairPoint cannot show that it will satisfy the service quality criteria, given the paucity of its available resources, the deficits in Verizon service quality that any successor will have to rectify, the daunting challenge of developing and flawlessly implementing an entire suite of new operations systems, FairPoint's own difficulties managing a much smaller transition in Maine, and FairPoint's lackluster approach to service quality in its existing Vermont and Maine service areas.

Given the difficulties experienced in regulating Verizon, the Commission may be tempted to allow Verizon to dump its system on "anybody but Verizon." Labor Exh. 1P at 18. Unfortunately, this would simply reward Verizon's poor performance, and in this case, would leave consumers open to grave risks of serious service quality troubles. Instead, this transaction should be rejected.

The risks of allowing FairPoint to assume ownership of Verizon NNE are simply too great. Rejecting this transaction would send an important message to Verizon. If Verizon still wants to sell its operations, it would need to "choose a buyer with the financial, technical and managerial resources needed to properly maintain and improve service quality." Labor Exh. 1P at 35.

H. If the Commission Determines to Approve the Proposed Transaction, It Should Strengthen the Service Quality Standards Applicable to FairPoint's Service Areas, Implement Penalties, and Enhance the Penalties for Repeat Violations.

If the Commission determines that FairPoint's severe financial deficiencies can be overcome (which, as Mr. Barber explains, does not appear likely), and thus if the Commission considers approving the merger, IBEW and CWA recommend that it should do so only if the transaction is conditioned on stringent service quality requirements, backed up by financial consequences sufficient to avert a "pay to play" response from FairPoint management. This is particularly important because Verizon witness Nestor acknowledged that for his company the level of penalties or bill credits (if any) is a consideration in determining whether to make investments in improving service. Tr. 10/31/07 at 174. Labor Intervenors also would recommend conditions intended to address FairPoint's lack of planning for possible workforce depletion.

With respect to service quality and customer service, as Dr. Peres outlines, the Commission should impose the following conditions on any transaction approval:

- Establish service quality standards and benchmarks with penalties (or customer rebates) that extend from the date of closing to five years after cutover.
- Update the existing benchmarks to ensure that there is no backsliding on standards that are currently being met or exceeded by Verizon.
- Add a new "duration of residential outages" standard.
- Impose progressively greater customer credits as service quality worsens, both within a year and from year to year.
- Require a comprehensive service quality audit if FairPoint fails to meet any individual service quality benchmark for three consecutive years.
- Require public reporting of service quality data, so that comparable information is publicly available on FairPoint's performance in all three Northern New England states. This will help the public and regulators assess whether FairPoint is deploying resources equitably throughout the region.

Labor Exh. 1P at 36-45.

These conditions take on added importance on account of the probable exodus of experienced workers, as well as the gap between FairPoint's stated promises and intentions on the one hand and its lack of any stated enforceable commitments.

Doubling the penalties if service falls below any benchmark for two consecutive years, both in terms of each individual benchmark and the total dollar amount at risk, would provide an incentive for FairPoint to fix problems as they occur. Id. at 42. The eroded quality of Verizon's customer service, coupled with FairPoint's plans to divert maintenance and capital investment in favor of dividend payouts, suggests that penalties are needed to keep FairPoint from allowing service quality to slip even further when it feels financial pressures.

If these measures are not enough to induce adequate service quality, the proposed comprehensive service quality performance audit would provide a form of backstop against FairPoint indifference. If FairPoint fails to meet any individual benchmark for three consecutive years, an audit would be conducted by an independent outside auditor, directed by the Commission and paid for by FairPoint. Labor Intervenors recommend that the audit include, but not be limited to, (a) the amount of network investment and resources dedicated to improving service quality, and the mix of these resources, (b) the adequacy of company records to locate and correct deficient equipment in a quick and efficient manner, and (c) the available workforce and the expected workload. The audit should document the reasons for poor service quality performance and make specific recommendations to improve service quality. The Commission, as a condition for any transaction approval, also should include a provision to require FairPoint to implement any of the audit's recommendations that the Commission adopts, to assure compliance with the service quality performance standards. Id. at 42-43.

Finally, Dr. Peres emphasized the importance of updating the service quality benchmarks to prevent backsliding. As he explained:

> [T]hree benchmarks would remain the same: That's held orders over five days, percentage out-of-service cleared within 24 hours, and percentage premise repair appointments missed. Those are three that Verizon has failed to meet. So because of that failure, the current benchmarks should, in my opinion, be retained. However, the other six standards have been attained by Verizon, and they have delivered service that has met the benchmarks.
>
> So, based really on a concept that I saw in a PUC order, the one in the Nynex Bell Atlantic merger -- and actually, I have a quote in that. It said, "In those cases in which Nynex is now exceeding the NARUC standards which were adopted as part of the Bell Atlantic Nynex order, <u>the standards should not be considered a new, lower target for performance</u>." The way I interpreted that is that there shouldn't be any back-sliding. So <u>if the transaction is approved, then consumers should not expect worse service than Verizon has delivered in those particular areas</u>. So the particular benchmarks I chose were based on the two best years, from 2003 to 2006; and in one instance with customer trouble report rate, it was from 1997 to '01, 2001, the best two years, the average. So there are two levels. One is to ensure that the service improve in those three areas, and on the six areas as per this table, that there be no back-sliding.

Tr. 10/31/07 at 202-03 (emphasis added).

V. Recommended Commission Action

A. The Proposed Transaction Does Not Promote the Public Good. The Commission, Therefore, Must Reject the Transaction.

Labor Intervenors have explained above that the proposed transaction does not promote the public good. FairPoint is not financially viable, which is likely to result in severe constraints on its ability to provide safe and reliable service in New Hampshire. Even under FairPoint's wildly optimistic financial assumptions, the company would not be financially stable. Under more realistic assumptions, FairPoint would be on the brink of financial collapse – approaching or exceeding the "worst case" scenario that was presented to FairPoint's board of directors.

These financial constraints – including lenders' restrictions on the level of FairPoint's capital expenditures – are likely to be so severe that they will directly affect FairPoint's ability to provide safe and reliable service to its customers. Everyone seems to recognize the challenge that FairPoint faces to try to improve the quality of service Verizon now provides. But without adequate financial resources, without enough people, and without the ability to invest in new plant and equipment, FairPoint will be unable to meet that challenge.

The Commission may find instructive a decision issued by the Montana Public Service Commission earlier this year. In *NorthWestern Corp.*, 2007 Mont. PUC LEXIS 54 (Mont. PSC July 31, 2007)[19], that commission rejected a proposed merger and acquisition because, in its words: "The overriding issue in the docket is whether the proposed transaction poses a threat to NorthWestern's financial health and, therefore, harm or risk of harm to Montana customers. The Commission finds that it does and explains its reasons below." Id. ¶ 143.

The Montana commission's analysis is directly applicable to this case. Indeed, the Montana commission found that its primary financial concern was that the acquiring company (BBIL) was projecting that it would require the utility (NorthWestern) to pay out more in dividends than the utility earned in net income. As the commission stated: "First and foremost, BBIL assumes NorthWestern will consistently pay out dividends to its new owner in excess of NorthWestern's net earnings. While U.S. utilities typically pay out 60 to 70 percent of net earnings in dividends, BBIL's acquisition model calls for in excess of 100 percent of net earnings to be paid out annually by NorthWestern through the year 2023." Id. ¶ 148.

The commission then explained as follows why this was so problematic for a public utility: "In normal utility operations, retained earnings provide a vital source of financial strength for capital investment and as reserves that are available during unexpected financial strains. Regularly paying out dividends in excess of net earnings by a utility is inappropriate and

[19] The order is also available on the Montana commission's web site at: < http://www.psc.state.mt.us/eDocs/eDocuments/pdfFiles/D2006-6-82_6754e.pdf >. Citations are to the numbered paragraphs in the order, which are the same in either the Lexis or web site versions of the order.

risky because having insufficient reserves on hand could adversely affect the utility's ability to provide adequate service." Id. ¶ 149.

Based on the acquiring company's financial projections, as well as its history of operations elsewhere, the commission concluded: "Given BBIL's dividend expectations and practices and the highly leveraged capital structures that BBIL has implemented at its existing operating subsidiaries, as well as the financial projections in the acquisition model, it is evident that BBIL's proposed ownership of NorthWestern presents the likelihood that NorthWestern's capital structure will deteriorate and become unacceptably leveraged." Id. ¶ 156 (emphasis added).

The Montana commission concluded, therefore, that the proposed purchaser was not financially viable and that the transaction was too risky for consumers. The commission decided that the existing utility's ownership was preferable to a new owner that was not financially viable. This was particularly true where that lack of viability would lead to the deterioration of the utility's capital structure. Thus, the commission concluded: "The Commission prefers the model of a stand-alone NorthWestern continuing to improve its financial outlook to the prospect of a BBIL-owned NorthWestern that is making excessive equity distributions to its owner, retaining insufficient earnings at the utility level, and experiencing a deteriorating capital structure – all to the detriment of the utility and Montana customers." Id. ¶ 180.

Each of the Montana commission's findings applies equally to FairPoint. Labor Intervenors submit, therefore, that the Commission should follow the reasoning of the Montana commission and reject this transaction. The proposed transaction is inconsistent with the public good and would expose the New Hampshire utility and the public to extraordinarily high financial risk, which is likely to lead to the deterioration of service.

Labor Intervenors recognize that Verizon has presented challenges to regulators. But it can get worse for New Hampshire, conceivably much worse, if this transaction is approved.

As Dr. Peres explained, rejecting this transaction would send a message to Verizon that it must improve its level of service and "choose a buyer with the financial, technical and managerial resources needed to properly maintain and improve service quality." Labor Exh. 1P at 35. Alternatively, of course, Verizon could choose to remain in business in New Hampshire and upgrade its level of service to at least meet the Commission's minimum standards.

B. If the Commission Disagrees, Then The Commission Must Impose Stringent Conditions to Protect the Public from Some of the Adverse Consequences of FairPoint Ownership.

1. Introduction

If the Commission disagrees and believes that it is possible to condition the transaction in such a way that the transaction would serve the public good, then Labor Intervenors submit that those conditions should accomplish three goals: (1) fundamentally change the nature of the transaction and the nature of FairPoint's operations going forward; (2) restrict FairPoint's financial decision-making so that the New Hampshire operations are required to retain adequate capital; and (3) ensure that service quality performance standards are coupled with strong financial incentives for compliance, eliminating the payment of penalties or credits as a viable business decision.

At the outset, though, Labor Intervenors would note FairPoint's reluctance to be bound by any serious financial conditions. Thus, for example, FairPoint witness Leach testified that the company's lenders would not permit FairPoint to agree to any restrictions on dividend payments. FairPoint Exh. 9HC at 99. In response to questioning, however, he acknowledged that FairPoint had in fact agreed to precisely these types of conditions in two other jurisdictions: New York and Illinois. Tr. 10/23/2007 at 23-33; Labor Exhs. 6P through 10P.

Moreover, earlier this year, FairPoint went back to the Illinois Commerce Commission for approval of the change in control that would be part of the proposed transaction. On June 27, 2007, the Illinois commission issued an order that approved the change in control, but required FairPoint to continue to be bound by those same dividend and cash transfer restrictions going forward. Labor Exh. 9P.

Yet before this Commission, FairPoint takes the position that it should not be subject to similar restrictions, and that its lenders would not permit it. FairPoint has failed to explain why it is permissible for its New York and Illinois consumers to have the protection of dividend restrictions, but it is impermissible for New Hampshire consumers to receive the same protection.

Similarly, FairPoint has not explained why it should not be bound by the same types of cash transfer restrictions – usually termed "ring fencing"[20] – that have been imposed on utility holding companies in several other states. For example, just during 2007 utility commissions in California, Colorado, Iowa, Oregon, and Washington have issued orders in cases involving mergers and reorganizations that contain precisely these types of restrictions.[21]

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[20] The California Public Utilities Commission recently defined ring fencing as follows: "Ring-fencing is the legal walling off of certain assets or liabilities within a corporation. Conceptually, in the context of a public utility within a holding company structure, ring-fencing includes a number of measures that may be implemented to protect the economic viability of the utility by insulating it from the potentially riskier activities of unregulated affiliates and thereby, ensuring the utility's financial stability and the reliability of its service." *Joint Application of SFPP, L.P. (PLC-9 Oil), CALNEV PIPE LINE, L.L.C., KINDER MORGAN, INC., and KNIGHT HOLDCO LLC,* 2007 Cal. PUC LEXIS 227 (Cal. PUC May 24, 2007), citing Beach Andrew N., Gunter J. Elert, Brook C. Hutton, and Miles H. Mitchell. Maryland Commission Staff Analysis of Ring-Fencing Measures For Investor-Owner Electric and Gas Utilities. The National Regulatory Research Institute-Volume 3, December 2005 at page 7.

[21] *Joint Application of SFPP, L.P. (PLC-9 Oil), CALNEV PIPE LINE, L.L.C., Kinder Morgan Inc., and Knight Holdco LLC*, 2007 Cal. PUC LEXIS 227 (Cal. PUC May 24, 2007); *Joint Application Of Kinder Morgan, Inc. Rocky Mountain Natural Gas Company, KN Wattenberg Transmission L.L.C., Source Gas Distribution, LLC, KM Retail Utility Holdco, LLC, Knight Holdco LLC, and Knight Acquisition Co.*, 2007 Colo. PUC LEXIS 174 (Colo. PUC Feb. 26, 2007); *Aquila, Inc.*, 2007 Iowa PUC LEXIS 341 (Ia. Util. Bd. Aug. 31, 2007); *MDU Resources Group, Inc.*, 2007 Ore. PUC LEXIS 242 (Ore. PUC July 25, 2007); *Application of Avista Corp.*, 256 P.U.R.4th 106 (Wash. UTC Feb. 28, 2007); *MDU Resources Group, Inc.*, and 2007 Wash. UTC LEXIS 411 (Wash. UTC June 27, 2007).

2. Fundamental Changes in Verizon and FairPoint

In effect, the only way to condition the transaction to serve the public interest is to fundamentally change the transaction. Specifically, the amount of cash FairPoint would have to pay should be severely reduced. This could be accomplished by requiring Verizon to bring its network up to standards – service quality standards, network operations, broadband availability, maintenance – prior to the system being turned over to FairPoint. Indeed, this could even include Verizon being required to provide FairPoint with a viable back-office operation (which could be achieved by having Verizon pay the TSA costs and the costs being incurred by FairPoint to Capgemini to build those systems).

3. Financial Conditions

Mr. Barber suggested the following financial conditions, which are modeled on the conditions FairPoint agreed to in Illinois and New York (Labor Exh. 2P at 55-56):

1. NNE will be prohibited from paying dividends to FairPoint Communications Inc. (or any other affiliate thereof) (collectively "FairPoint Parent") or from otherwise transferring cash to FairPoint Parent through loans, advances, investments or other means that would divert NNE's moneys, property or other resources that is not essentially or directly connected with the provision of non-competitive telecommunications service if NNE fails to meet or exceed the standard for a majority of the service quality measures (see the testimony of Dr. Peres for the types of service quality conditions that should be established for FairPoint).

2. Dividends on common stock of FairPoint's existing operations in New Hampshire must be suspended if service quality at FairPoint's existing operations in New Hampshire deteriorates, using the same criteria to be established for NNE (as discussed by Dr. Peres).

3. The financing for the acquisition will not be secured by NNE's assets, nor shall NNE or its affiliates be allowed to pledge NNE's assets.

4. NNE will not provide any financial guarantees to facilitate this, or any other acquisition.

5. The amount of annual dividends NNE can distribute to FairPoint Parent is further limited as follows:

    a. The cumulative dividend NNE can declare in any year may not exceed the difference between that year's earnings (income or loss) before interest, taxes, depreciation, and amortization (EBITDA) and 100% of its depreciation expense. This restriction will require that an amount of cash, equal to 100% of that year's depreciation expense, will be available for NNE’s capital expenditures.

    b. In any year that the amount of depreciation expense retained by NNE is in excess of its capital expenditures, NNE shall account for such funds in a subaccount of Account 1410, Other Noncurrent Assets. The cumulative annual depreciation expense retained at NNE will assure adequate funds are available to complete future capital expenditures, as required.

    c. In years when the total depreciation expense does not cover capital expenditures, NNE may use the accumulated depreciation funds to pay for this incremental amount of capital expenditures, provided that NNE notifies the Commission of such a need no later than 45-days prior to the use of the funds.

    d. Suspend this dividend restriction to the extent NNE is able to maintain an average daily balance in the depreciation fund subaccount of Account 1410 for a calendar year of 1.0 times its average annual capital expenditures for the last five calendar years. The dividend restriction will become operative whenever this criterion is not satisfied. Further, we will suspend the restriction if FairPoint obtains an investment grade bond rating.

6. NNE must maintain a consolidated common equity ratio of at least 40% of total capitalization before any declaration of a dividend on common stock. Total capitalization includes: long term debt (including current sinking fund requirements), short term debt (including capital leases), minority interest, and stockholders' equity. Further, no dividend payment will be permitted which would cause NNE’s consolidated common equity ratio to fall below 40%.

7. NNE and its subsidiaries shall be prohibited from making any loans or financial advances to FairPoint.

4. Service Quality Conditions

As explained in Section IV.H., above, if the Commission decides not to reject the transaction, then it should adopt the following service quality conditions:

- Establish service quality standards and benchmarks with penalties (or customer rebates) that extend from the date of closing to five years after cutover.
- Update the existing benchmarks to ensure that there is no backsliding on standards that are currently being met or exceeded by Verizon.
- Add a new “duration of residential outages” standard.
- Impose progressively greater customer credits as service quality worsens, both within a year and from year to year.
- Require a comprehensive service quality audit if FairPoint fails to meet any individual service quality benchmark for three consecutive years.
- Require public reporting of service quality data, so that comparable information is publicly available on FairPoint’s performance in all three Northern New England states. This will help the public and regulators assess whether FairPoint is deploying resources equitably throughout the region.

VI. Conclusion

For the reasons set forth above, the Communications Workers and America and the International Brotherhood of Electrical Workers respectfully request the Public Utilities Commission to reject the Application. FairPoint Communications is not financially fit to own and operate Verizon New Hampshire and the other Verizon Northern New England operations. FairPoint Communications has not demonstrated either the commitment or expertise to provide adequate service to New Hampshire consumers on an on-going basis. There is no set of conditions that would cure these fundamental problems with the transaction. The Public Utilities Commission, therefore, must reject the proposed transaction as being contrary to the public good.

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