

STATE OF NEW HAMPSHIRE
BEFORE THE
PUBLIC UTILITIES COMMISSION

DT 07-011

**Joint Petition by Verizon New England, Inc., et al. and
FairPoint Communications, Inc.
Transfer of New Hampshire Assets of
Verizon New England, Inc. et al.**

**Prefiled Direct Testimony of Michael J. Balhoff
On Behalf of
FairPoint Communications, Inc.**

March 23, 2007

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1 **INTRODUCTION**

2 **Q. Would you please state your name and position for the record?**

3 **A.** My name is Michael J. Balhoff. I am Managing Partner of Balhoff & Rowe, LLC, and
4 my business address is 5457 Twin Knolls Road, Suite 101, Columbia, MD 21045.

5

6 **Q. Please explain the history of Balhoff & Rowe.**

7 **A.** I founded Balhoff & Associates, LLC, in 2004, and subsequently renamed the firm
8 Balhoff & Rowe, LLC, in 2005 when I partnered with Robert C. Rowe, the former
9 chairman of the Montana Public Service Commission. Mr. Rowe completed his 12-year
10 term as a state public utility regulatory commissioner at the end of 2004.

11 **Q. What service does your firm provide?**

12 **A.** In conjunction with other professional personnel, we provide advisory services, including
13 financial and regulatory consulting to various telecommunications, cable and energy
14 companies.

15

16 **Q. Please describe your educational and professional background.**

17 **A.** I have a doctorate degree in Canon Law from The Catholic University of America and
18 four masters degrees, including an M.B.A. from the University of Maryland. I am a
19 Chartered Financial Analyst and am a member of the Baltimore Security Analysts
20 Society.

21

1 Before starting my own firm, I directed the telecom sell-side equity research group at
2 Legg Mason in Baltimore for 16 years. In that role, I staffed and supervised the
3 independent equity research group covering local exchange carriers, long-distance
4 providers, and competitive local exchange carriers. The group also provided coverage of
5 media, wireless services, cable TV, and communications equipment companies, and
6 offered one of the most extensive telecom and media regulatory research services among
7 Wall Street firms. Legg Mason was, at that time, a full-service investment firm that
8 provided money management, retail brokerage, capital markets products, and investment
9 advice to a wide range of companies and prominent institutional investors across both
10 North America and Europe.

11
12 Over the last seven years of my time at Legg Mason, I focused my coverage on local
13 exchange telephone companies, including the regional Bell operating companies
14 (RBOCs) and a wide range of rural telephone companies. At Legg Mason, I provided
15 detailed coverage of rural telephony and the specific questions that arise related to the
16 financial effects of regulation on that industry segment. I also analyzed the strategic
17 merit of rural telephone companies acquiring smaller urban and rural properties from the
18 RBOCs. See, especially, Michael J. Balhoff et al., *Reshaping Rural Telephone Markets:
19 Financial Perspectives on Integrating Acquired Access Lines*, Fall 2001: Legg Mason
20 Research, Baltimore, MD.

21
22 **Q. What is your relationship with the companies in this proceeding?**

1 **A.** Since I left Legg Mason, my firm has been providing financially-based and regulatory-
2 based services to various communications companies. For the last two years, we have
3 offered consulting advice to several mid-size rural telephone companies in an ongoing
4 strategic assessment of the financial and regulatory forces affecting the rural
5 telecommunications industry. FairPoint Communications is one of those companies. We
6 have provided consulting advice to FairPoint before and since the time FairPoint began
7 assessing the acquisition of Verizon's local exchange properties in northern New
8 England. Finally and separately, last year, in a project independent of this one, we also
9 studied municipal wireless and fiber trends and published a report that was paid for in
10 part by Verizon; FairPoint did not participate in this project.

11

12 **Q.** **On whose behalf are you testifying?**

13 **A.** I am testifying on behalf of FairPoint in support of the regulatory approvals required for
14 this transaction.

15 **PURPOSE OF TESTIMONY**

16 **Q.** **What is the purpose of your testimony in this proceeding?**

17 **A.** I have been asked by FairPoint to offer my opinion as a financial expert in the
18 telecommunications capital markets regarding industry trends affecting local exchange
19 services in smaller markets, the financial commitment of FairPoint to the exchanges
20 being acquired from Verizon, and FairPoint's financial strength.

21

22 **Q.** **Can you please summarize your testimony?**

23 **A.** I will make three fundamental points.

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The telecommunications industry increasingly requires clear strategic choices. The industry trends affecting local exchange carriers (LECs) involve increasing competitive and financial pressures that are forcing all carriers—including incumbent LECs (ILECs)—to make clear strategic choices. The shift from monopoly to often vigorous competition combined with emerging technologies has sharpened the need for companies in this industry (1) assess the long-term and intermediate-term opportunity to generate returns that meet their fiduciary obligations to their shareholders, (2) evaluate realistically the appropriate application of their capital and human resources to respond to meaningful competitive pressures, and (3) execute sharply-defined strategies to achieve a defensible operational position within the competitive marketplace.

Both FairPoint and Verizon are making necessary strategic choices about rural and smaller urban markets. Regulators should focus on FairPoint’s well-defined strategic plan to invest in rural and small urban local markets. The decision to expand the company’s operations in northern New England is sensibly conceived and wholly consistent with that strategy. Verizon unquestionably has multiple internal strategic opportunities that compete for its capital. Verizon’s current corporate strategy appears to prioritize its investment outside northern New England’s wireline operations.

FairPoint’s capital commitment is sufficient to satisfy public policy goals. From a financial point of view, FairPoint’s plans to invest in this market represent a clear commitment to strengthen the ILEC’s network and services, and to enhance consumer

1 choice in northern New England. The results should be positive for all the stakeholders,
2 which include customers and investors. If this is the case, the *central question for*
3 *regulators should be whether FairPoint reasonably has the financial and operational*
4 *strength to accomplish such a pledge.* Notably, Verizon, FairPoint, the projected lenders
5 and the equity investors are focused on cash flows, which should provide a direct
6 determinant of the company's strength. Mr. Leach presents FairPoint's detailed
7 operating and cash flow models. In my opinion, those models are based on realistic
8 expectations that the company can improve operations. Alternatively, the models are
9 based on assumptions that reflect industry trends. I have reviewed those projections and
10 believe that they are reasonable and prudently designed. I note that Verizon recently
11 delivered to FairPoint the audited financial statements from 2006 operations, and
12 FairPoint has refined its expectations, which have been included in the model I have
13 reviewed. I believe that the model supports the contention that FairPoint will be a solid
14 provider of services and a competitive carrier.

15 **TELECOMMUNICATIONS INDUSTRY REQUIRES CLEAR STRATEGIC CHOICES**

16 **Q. What do you mean when you say that the telecommunications industry is requiring**
17 **increasingly clear strategic choices?**

18 **A.** New technologies and competitive pressures are changing the operating fundamentals of
19 all telecommunications carriers, including LECs. Over the last ten years, there has been a
20 concerted movement to acquire certain business capabilities and recombine certain Bell
21 Operating Company (BOC) and independent (e.g., GTE) local exchange assets to gain
22 scale in order to operate more effectively in the face of increasing competition and often
23 to gain greater wireless reach. More recently, in 2005 and 2006, there has been a focus

1 on the vertical integration of local and long-distance assets, including enterprise-oriented
2 operations. In addition, over the last two years, BOC initiatives to add video services to
3 their product offerings have increased in the form of significant network upgrades in
4 certain markets and state-level television franchising initiatives. These factors reflect a
5 new world in which competition is unfolding, significantly driven by new technology
6 platforms based on Internet Protocol and new wireless protocols. As competition
7 increases in various markets, strategic clarity regarding the markets that a company will
8 target and where it can most productively deploy its resources becomes critical if it is to
9 maintain its financial health and maximize returns for its shareholders.

10
11 **Q. Is telecommunications consolidation merely a matter of large carriers getting**
12 **larger?**

13 **A.** No. The capital markets recognize the risk in gaining size if companies lose operational
14 focus and effectiveness. The public market valuations of companies can be discounted
15 for diversified businesses that are not integrated strategically. I contend that much of the
16 recent merger activity among the larger wireline telecommunications carriers is *not* about
17 recombining the old Bell system, but *is driven by strategic decisions to concentrate cash*
18 *flows* on profitable business customers and densely-populated regions. The strategy for
19 larger carriers is to serve regional, national and international markets with wireline assets
20 and superior wireless platforms. As a result, large carriers are rigorously re-inventing
21 themselves through a rational concentration of specific assets—business-centered,
22 broadband, data and wireless. At the same time, they are asking themselves about
23 whether to maintain or divest non-strategic assets, and potentially how to rededicate those

1 cash flows to more strategic objectives. Illustrating the trend of the larger carriers
2 prioritizing business, broadband and wireless operations in plotting their course for the
3 future, the most frequently cited rationale given for the recent merger between AT&T and
4 BellSouth (historically focused on providing wireline services) is the need to consolidate
5 full operational control of Cingular Wireless (the two companies' wireless joint venture)
6 into a single company.

7
8 **Q. Does the shift in strategic focus mean that wireline operations are no longer**
9 **attractive to BOCs and that consumers will receive sub-par service from BOCs?**

10 **A.** No. I believe that the BOCs continue to be committed to providing excellent service to
11 their wireline customers. However, policymakers should recognize that there are also
12 irrevocable forces that have been unleashed in the marketplace. Those forces are now
13 precipitating more competition, significant line loss, meaningful cash flow pressures, and
14 strategic evaluations.

15 **FAIRPOINT AND VERIZON FOCUSING ON STRATEGIC MARKETS**

16 **Q. Will smaller market properties therefore be divested and receive lesser service?**

17 **A.** The pressure will continue to divest certain assets and reinvest in strategic operations.
18 Many investors now believe that there will be an emerging segmentation of the wireline
19 telecommunications industry. The BOCs will increasingly focus on national wireless
20 platforms, broadband and new video services, all of which are capital intensive. Smaller
21 markets will often require a different kind of operator with a strategic focus that is
22 distinguished from service to denser and more national markets. The recent divestitures
23 of local assets by Sprint into Embarq and Alltel into Windstream are signals of this

1 movement to further align strategy and operations in transactions that are similar in terms
2 of the kinds of markets divested. Before the announcement of this transaction, Verizon
3 had sold approximately 3 million lines since 1996.

4
5 **Q. What do you mean that smaller markets require a different kind of operator?**

6 **A.** I believe that most policymakers recognize the excellence of the small-market business
7 operations at specialized operators such as FairPoint, CenturyTel, Citizens, Windstream,
8 Embarq, Iowa Telecom and Consolidated Communications. While these carriers do not
9 have the size, the capital or the diversification of the operations of the BOCs, they are
10 focused strategically on wireline telecommunications service for smaller urban and rural
11 markets in terms of investment, products, local presence within their communities,
12 dedication to relatively higher penetration of broadband in less-dense regions, and
13 collaboration with local policymakers. In virtually every divestiture/acquisition of rural
14 lines that I have studied, the per-line investment increased, revenues grew because of the
15 introduction of additional products and/or the incremental penetration of existing
16 products, and broadband services expanded.¹ Rural carriers invested as much as \$400
17 per line to rehabilitate certain “distressed” plant, and have consistently committed to
18 expanding high-speed capacity/availability that generally increased the reach of
19 broadband from 20%-30% to 60%–70%, and have provided a range of custom calling or
20 extended-area-calling services that were more extensive than what was previously

¹ See, for example, Balhoff, *Reshaping Rural Telephone Markets*, esp. pp. 37-108, where four case studies affecting 2.2 million lines are considered.

1 available. In every such divestiture/acquisition with which I am familiar, the acquired
2 properties benefited from higher levels of investment and a broader set of services.

3
4 **Q. There has been extensive discussion of fiber to the home versus DSL. Would the
5 public interest be better served by requiring fiber to the premises?**

6 **A.** In my opinion, no. I note three important factors. First, Verizon's FiOS, which is the
7 only widespread fiber-to-the-premises (FTTP) commitment in the U.S., is generally
8 regarded by the trade pundits and the financial community as a high-risk proposition,
9 involving historically unprecedented per-line investment to deploy a very high
10 bandwidth, "future-proof" network. There continue to be vigorous debates about whether
11 fiber to the home can be justified financially in terms of the level of investment, the speed
12 to market, an increasing commoditization of the "pipes," and ultimately the return
13 potential on the FTTP capital deployed.

14
15 Second, it is worth noting explicitly that the major carriers are committing to fiber-based
16 services only in certain denser regions—because it is necessary to prove the business case
17 and because the returns on such a significant investment are being scrutinized carefully
18 by institutional and retail investors. It is my opinion that today's case for fiber-to-the-
19 home or fiber-to-the-node in smaller urban or rural markets is more difficult to justify
20 unless there are other financial supports such as economic development or tax incentives.

21
22 Third, investors assign discounts to the securities of companies sponsoring higher-risk
23 investment such as FTTP. Carriers are not able at this time to justify clearly to investors

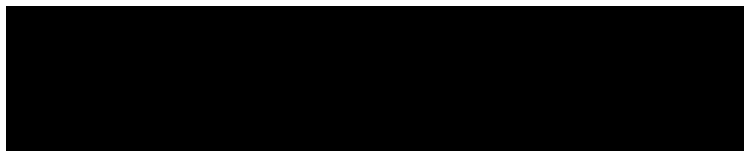
1 that FTTP is a winning proposition. My conviction as a financial analyst is that any
 2 company's stock would be punished if there were a commitment to widespread fiber
 3 deployments in lesser-density regions.

4
 5 **Q. What are the financial differences between fiber-to-the-home and DSL investment?**

6 **A.** The capital cost of deploying fiber-to-the-curb, using a BOC's purchasing power is about
 7 \$873 per home passed on average, with an additional \$933 to extend fiber all the way to a
 8 home and activate the service.² DSL investment cost varies, but I believe that FairPoint's
 9 investment will be approximately consistent with the data found in Table 1. If the DSL
 10 modem is purchased by the customer, the required investment to provide DSL is reduced
 11 to about \$235 per home versus fiber capital investment for which the low investment is
 12 approximately \$1,800 per home. Although the costs of fiber to the premises may
 13 decrease with scale, the capital investment per home is still substantially more than the
 14 investment for DSL, and can only be offered in markets with the most attractive potential
 15 in terms of revenues and network utilization.

16 **Table 1: Fiber investment v. DSL investment per home**

17



18
 19 Source: Verizon Analyst Call, September 27, 2006; industry data related to DSL.

² See Verizon Communications Inc., "FiOS Briefing Session," September 27, 2006 (Webcast presentation for financial analysts), slides 24-25; available at <http://investor.verizon.com/news/20060927/20060927.pdf>.

1 **Q. Does such a non-fiber scenario mean that smaller and rural markets will only have**
2 **low-speed services?**

3 **A.** No. Alternative technologies provide high-speed services today and consumers are
4 largely indifferent to the specific kind of transport used to provide those services. DSL
5 speeds have continued to improve as the technologies develop and as the loop lengths
6 shorten, providing downstream broadband access at speeds of 3 megabits per second
7 (Mbps) or sometimes 10+ Mbps. Cable operators are achieving throughput speeds of 6+
8 and even 10+ Mbps using coaxial cable drops, and Wi-Fi services are providing high-
9 speed access at throughput speeds of 56 Mbps and higher. Wi-MAX services are
10 expected to allow carriers—incumbents and competitors— cost-effectively to provision
11 wireless high-speed services that purportedly can be served by a single cell site over as
12 much as 30 miles. Broadband over power lines continues to hold promise.

13

14 **FOCUS ON FAIRPOINT'S CAPITAL INVESTMENT AND CASH FLOWS**

15 **Q. What do you mean that the focus should be on FairPoint's capital investment?**

16 **A.** I believe that the fundamental question about whether this transaction will promote the
17 public good turns on post-merger FairPoint's ability to focus capital investment in the
18 region, as demonstrated in company's expectations for capital expenditures per line, in
19 the company's commitment to expand the geographic area where DSL is available, and
20 the plan to broaden the types of service bundles offered to consumers, to support/grow
21 the number of people it employs in the region, and to open new local support service
22 centers.

23

1 **Q. Is FairPoint going to commit the necessary capital to ensure high quality service**
2 **over the local assets?**

3 **A.** FairPoint is planning to dedicate approximately ****\$____**** per switched access line in
4 2008, with planned per-line investment rising annually through 2012 when the projection
5 is for capex of ****\$____**** per line. FairPoint anticipates raising the per-line investment
6 as reflected in Table 2, in part to support expanding broadband availability. To achieve
7 these higher levels of broadband availability, FairPoint will install or expand fiber routes
8 connecting the Central Offices and remote sites to accommodate the additional
9 bandwidth requirements created by the broadband expansion commitment. Therefore,
10 FairPoint is committing to the expansion of the fiber network, but is generally limiting
11 such fiber investment to transport versus direct fiber connections to the home. The
12 higher investment is, in part, made possible by the attractive structure of the transaction
13 through the tax-advantaged Reverse Morris Trust, which allows for a lower purchase
14 price leaving more funds available for the broadband expansion.

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Q. How does the Reverse Morris Trust work?

A. As Verizon explains in more detail in its testimony, a Reverse Morris Trust provides a financially-attractive method for a corporation to divest assets or business operations in a non-taxable transaction. A spin-off of a subsidiary—such as the local telephone operations in Maine, New Hampshire and Vermont—is followed immediately by a merger of the spun-off entity with a third party—in this case FairPoint. The divesting company’s (Verizon’s) shareholders must have a greater than 50% ownership of the eventual merged entity. Here, Verizon is merging approximately 1.5 million voice access lines in northern New England with a company that, at the end of the fourth quarter of 2006, had 251,706 voice access lines. I note that some commentators have raised a question about whether FairPoint’s size is a liability, but it is in part that size difference that makes the transaction financially attractive. A tax-advantaged Reverse Morris Trust would not have been possible, for example, in combining assets with other rural specialists such as Embarq (7.0 million lines), Windstream (3.3 million lines), CenturyTel (2.1 million lines), or Citizens (2.1 million lines), because those companies would have had a *greater than 50% stake in the eventual merged company* which would have caused the transaction to be taxable and therefore more costly.

Q. What are the benefits of this tax-savings approach to ratepayers?

1 **A.** Ratepayers clearly benefit. The tax savings make possible a transaction that might not
2 otherwise occur, and almost certainly not at the price agreed to here. The reduced price
3 ensures a financially stronger local telephone company—FairPoint—which is able to
4 provide good service, invest in new network/products, and keep rates at affordable levels.
5 Ratepayers benefit in the form of increased investment, improved services, and a more
6 focused operation, as will be examined below. The bottom line is that a financially-
7 sound transaction should generate benefits for all stakeholders—seller, purchaser,
8 employees, consumers, policymakers, and investors who provide the debt and equity
9 capital.

10

11 **Q.** **How do you recommend that policymakers should review this transaction from a**
12 **financial point of view?**

13 **A.** In terms of the financial perspective, policymakers should consider whether FairPoint has
14 the ability to generate realistic cash flows to meet its pledge to increase capital
15 commitments and to fulfill its obligations to its employees. In the unlikely event that the
16 operating environment proves more negative than the company’s modeling, I think it is
17 also notable that the company has the flexibility to meet its obligations in several other
18 ways. Those options include the opportunity to further reduce line losses, add
19 incremental revenues through new products, adjust the company’s cost structure, scale
20 capital expenditures or alter the company’s dividend policy. The final two options would
21 only be invoked if the operations became distressed, which I do not expect. However, the
22 flexibility is highlighted so that policymakers can better understand alternative

1 approaches the company has at its disposal even if there are unforeseen factors that
2 dramatically alter the outlook.

3
4 **Q. Why should policymakers focus on cash flows as the appropriate measure of**
5 **financial viability?**

6 **A.** Policymakers can and likely will review the financial soundness of this transaction in a
7 variety of ways. However, the most fundamental indication of the financial viability of a
8 company is its ability to generate cash from operations sufficient to cover all of its cash
9 obligations. I contend that audited financial statements and balance sheets, while very
10 informative, frequently are impacted by accounting conventions in ways that can mask
11 the true financial health of an entity, both positively and negatively. However, as the
12 saying goes, “you can’t fake cash.” This means that the cash flows generated by a
13 company are the most accurate indicators of its ongoing value. In fact, it is not
14 uncommon for the public equity markets to value the equity of a company well in excess
15 of the book equity value to reflect the value of cash flows. FairPoint itself is an example
16 of this phenomenon, with a market-based equity value approximately three times greater
17 than its book equity value. In the instance of this combination of FairPoint and northern
18 New England assets, the resulting book equity significantly understates the true value of
19 the company due to the accounting conventions associated with the Reverse Morris Trust
20 transaction structure.

21
22 **Q. How is the company to be capitalized?**

1 **A.** Regulators should note several pertinent factors about the capitalization. First, the
2 northern New England assets are being funded by FairPoint at the parent level with about
3 37% equity and 63% debt. Moreover, the capitalization of the regulated operating entity
4 is 100% equity, as no debt is to be issued by the regulated entity, and the regulated assets
5 will not be pledged as security for any borrowings. The parent company, FairPoint,
6 which owns the stock of the regulated and unregulated subsidiaries, will be issuing and is
7 obligated to repay the debt reported on the consolidated balance sheet. FairPoint's stock
8 is to be pledged as the security for the new debt. Second, in my estimation, the combined
9 company generates sufficient cash flow to support the proposed pro forma capitalization.
10 If the cash flows support the capital structure, then investors and regulators should be
11 satisfied. As discussed below, I believe that FairPoint can and does demonstrate that its
12 cash flows are sufficient in building an even stronger and more focused local telephone
13 company.

14

15 **Q. Should policymakers be concerned at all about the book equity of the parent?**

16 **A.** No. First, and most fundamentally, there is economic value in this transaction that does
17 not translate into book equity as a result of the transaction structure. In fact, the value of
18 the underlying assets is greater than the book equity, but the tax-advantaged treatment
19 does not permit the company to mark the assets to market value. Second, the acquirer
20 and the seller are assessing the cash flows to arrive at a fair value, which means that book
21 equity as a proxy for economic value is not what operating companies are evaluating.
22 Third, the capital markets, which have evaluated this transaction, modestly "bid up"
23 FairPoint's stock price following the announcement of the transaction because of the

1 perceived value that will be generated by ongoing cash flows. In short, the financial
2 markets and industry operators are all focused in this transaction on the cash flow
3 characteristics, which generate the acid test of economic value. Given that the financial
4 markets will provide the company ongoing access to capital, their evaluation of the
5 financial soundness of this transaction should be given significant weight.

6
7 **Q. What FairPoint financial model have you reviewed?**

8 **A.** I have assessed the FairPoint the financial model that was the basis for the decision to
9 enter into this merger agreement. That model was presented to FairPoint's Board of
10 Directors over the last half of 2006 and continually updated as additional due diligence
11 activity was completed, with a final model being reviewed in early January 2007.
12 Although a model through 2015 was prepared and reviewed by the FairPoint Board of
13 Directors, this testimony focuses on the first five years (through 2012) as the most
14 relevant time frame. ****PROPRIETARY****

15
16
17 The company believes that the later years will be positively impacted by the addition
18 of new services and potentially by additional acquisitions by FairPoint. The exclusion
19 of these items from the model further supports my view that the model is
20 reasonable.

21
22 I have two basic observations about the model. First, the model reflects reasonable or
23 even conservative industry trends, margins, and capital commitments. Second, FairPoint

1 has sufficient options by which it would be able to generate incremental cash flows
2 beyond those reflected in the model even if the projections are affected negatively by
3 market factors that are not within reasonable planning assumptions.

4 **Q. Are the models optimistic in your opinion?**

5 **A.** No. In my opinion, FairPoint has used industry metrics to arrive at its best estimation of
6 a base case. I have summarized key operating statistics in Table 3. The table is based on
7 the model that Mr. Leach presents, but I have included specific data that clarify the points
8 I believe are pertinent in this review.

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10 **END CONFIDENTIAL INFORMATION****

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12 **CONCLUSION**

13 **Q. What are your summary observations?**

14 **A.** I believe that FairPoint is clear in its commitment to higher levels of capital expenditures
15 in the northern New England properties, and has a convincing model that supports that
16 level of investment. Even if results are somewhat less than projected by the model,
17 FairPoint will be able to generate clear benefits for customers, employees, policymakers
18 and investors. The model is reasonable as it anticipates ongoing line losses even as the
19 company maintains a relatively stable level of operating expenses. The resulting cash
20 flows are stable throughout the five-year plan, and even if there were to be shortfalls in
21 several assumptions, the company has the ability to offset those shortfalls and generate
22 higher cash flows.

23

1 **Q.** Does this conclude your testimony?

2 **A.** It does.