Staff Advocate 1 P

STATE OF NEW HAMPSHIRE

PUBLIC UTILITIES COMMISSION

DT 10-025

Reorganization of FairPoint

Direct Testimony

of

Kathryn M. Bailey
on behalf of Staff Advocates

March 5, 2010

Q. Please state your name, occupation and business address.

A. My name is Kathryn M. Bailey. I am employed by the New Hampshire Public Utilities Commission (Commission) as Director of the Telecommunications Division. My business address is 21 South Fruit Street, Concord, New Hampshire 03301.

Q. Please summarize your educational and professional background.

A. Please see Attachment 1.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to explain the ways in which the settlement agreement between FairPoint and the Staff Advocates, dated February 5, 2010, (Regulatory Settlement) preserves, with some modifications, the commitments FairPoint made, and the Commission relied upon, when the Commission approved the transfer of Verizon assets to FairPoint in Docket No. DT 07-011 by Order No. 24,823, dated February 25, 2008 (2008 Order).

Q. What were the primary commitments FairPoint made?

A. The primary commitments FairPoint made in the January 23, 2008 Settlement Agreement (2008 Agreement) are too detailed to recite here but are summarized in the conclusion of the 2008 Order:

> FairPoint has made commitments that are calculated to promote the financial health of its regulated operations in New Hampshire. It has also made binding promises about service quality, relations with wholesale competitors, cooperation with other users of utility poles, and broadband build out.

Q. Does the Regulatory Settlement propose to modify each of these commitments?

A. No. The Regulatory Settlement proposes to defer, and under certain circumstances waive, service quality penalties for 2009; eliminate DSL service quality reporting commitments and stand-alone DSL pricing; make slight modifications to the timing of the broadband availability commitment as well as the associated penalties for failure to meet the commitment; and clarify the capital expenditure commitments. With the exception of Section 2 in the 2008 Agreement, and the specific modifications included in the Regulatory Settlement, the remaining provisions in the 2008 Agreement are unchanged by the Regulatory Settlement.

Q. Please explain the proposal regarding retail service quality.

A. Going forward, the Regulatory Settlement preserves the service quality benchmarks and associated penalties established in the 2008 Agreement. The 2009 retail service quality penalties, however, would be deferred until the end of 2010. The 2009 retail service quality penalties would be waived if FairPoint achieves the benchmarks in 2010 for five key retail service metrics: percent installation appointments met, percent installation service orders met within 30 days, customer trouble reports per 100 lines, percent out-of-service cleared within 24 hours and percent repair appointments met. The entire 2009 retail service quality penalty would be reduced by 20% for each benchmark FairPoint achieves in 2010 on these key service metrics. As a result, if FairPoint achieves compliance with each of the five specified metrics in 2010, the entire 2009 penalty would be waived.

Q. Why is it reasonable to allow a waiver of the 2009 retail service quality penalties?

A. The regulatory goal of service quality penalties is to insure good service quality. Although service quality was unacceptable in 2009, there is a possibility that the bankruptcy court could determine that penalties accrued before FairPoint filed for Chapter 11 protection would be discharged without any special priority. The Staff Advocates also concluded that it would be reasonable to provide an additional incentive to achieve the expected service quality benchmarks in 2010. The deferral and possible waiver of 2009 retail service quality penalties provides an opportunity for FairPoint to focus on and improve service quality.

Q. Please explain why it was necessary to clarify Section 4 of Exhibit 3 (FairPoint Retail Quality of Service Commitments) in the 2008 Agreement.

A. The intent of the 2008 Agreement was to have retail service quality penalties in New Hampshire equivalent to those in Maine. However, Maine retail service quality metrics are reported as the inverse of what is reported in New Hampshire. For example, one New Hampshire metric requires 90 percent of installation commitments be achieved. The Maine metric allows FairPoint to miss up to 10 percent of its installation commitments. The penalty calculation is based on the percentage of the metric missed. If FairPoint achieves 80% installation commitments in New Hampshire, it has missed the metric by 10 percentage points or approximately 11% of the metric. In Maine, if FairPoint provides the same level of service, reported as 20% installation commitments not met, it has missed the metric by 100% and the calculated penalty is nearly ten times greater. Section 2.3 in the Regulatory Settlement clarifies that the calculation of retail service quality penalties should produce equivalent penalties in Maine and New Hampshire for the same level of service, irrespective of how the metric is reported.

Q. Please explain how Section 2.3 in the Regulatory Settlement modifies DSL service quality metrics in Section 3.2 of Exhibit 3 to the 2008 Agreement.

A. The intent of this language in the 2008 Agreement was to monitor how long it took FairPoint to install DSL. In attempting to determine how to measure DSL installation time, it became apparent that this type of measurement could not be performed the same way dial tone installation times are measured. When a customer orders DSL at a qualified address, FairPoint is required to perform work in its central office and often simply mails a modem to the customer. The customer completes the installation and FairPoint does not necessarily know precisely when the installation is completed. Because completion of the installation is customer dependent and because the Commission has limited jurisdiction over DSL, the Staff Advocates agreed to eliminate this measurement from service quality reporting and penalties.

Q. What does the Regulatory Agreement propose to do with stand-alone DSL pricing obligations?

A. Section 3.7 in the 2008 Agreement requires FairPoint to offer stand-alone DSL and limits annual price increases to 15%, unless otherwise approved by the Commission. In light of the Commission's limited role with respect to DSL pricing, the Staff Advocates agreed to eliminate the requirement for Commission approval of stand-alone DSL pricing. The Regulatory Settlement maintains the requirement to offer stand-alone DSL.

Q. Does the Regulatory Settlement preserve FairPoint's commitment to make broadband available to 95 percent of its access lines within 60 months following the Closing Date, by April 1, 2013?

A. Yes, the Regulatory Settlement preserves the commitment to achieve 95% broadband availability by April 1, 2013. It also preserves FairPoint's commitment to spend at least $56.4 million on broadband deployment.

Q. How does the Regulatory Settlement change the broadband commitments?

A. The 2008 Agreement established interim milestones of 75% and 85% broadband availability toward achieving the ultimate goal of 95% broadband availability at set target dates. The Regulatory Settlement proposes to change the interim target date for 85% broadband availability from April 1, 2010, to December 31, 2010. Given the financial difficulties FairPoint experienced in 2009, it is reasonable to allow additional time to accomplish 85% availability. This modification preserves the ultimate goal of achieving 95% broadband availability by April 1, 2013.

Q. Have the penalty provisions for failure to achieve broadband availability milestones been modified?

A. The amount of penalty dollars at stake and the frequency of penalty calculations for failure to achieve broadband availability milestones have not been modified. The 2008 Agreement required FairPoint to pay penalties to the Telecommunications Planning and Development Fund administered by the Department of Resources and Economic Development. Section 2.7 of the Regulatory Settlement, however, allows FairPoint to retain the penalty money, above the first $500,000, and requires FairPoint to invest the penalties in its New Hampshire network, on projects approved by the Commission. If FairPoint is required to pay broadband penalties, the first $500,000 will be paid to the Telecommunications Planning and Development Fund and all penalties thereafter, if applicable, would be retained by FairPoint for investment in not otherwise required capital expenditures approved by the Commission.

Q. Can FairPoint resell another carrier's broadband, as described in Section 2.6 of the Regulatory Settlement, to satisfy the last 8% of the broadband availability commitments made in the 2008 Agreement?

A. Yes. The terms in section 2.6 of the Regulatory Settlement would permit FairPoint to form a partnership with another provider, perhaps a fourth generation wireless provider, to share the costs of providing service in the areas of the state most expensive to serve. An optional provision such as this may provide an incentive for a wireless carrier to deploy wireless service in a remote area if it can rely on a partnership from FairPoint who is required to deploy broadband service in the area. Under this type of arrangement, FairPoint would be required to sell the broadband service to its end-users and the service offered must meet or exceed the requirements in the 2008 Order. It could also have the effect of achieving wider wireless availability in hard-to-reach areas of the state.

Q. Has the amount of FairPoint's capital expenditure commitments been altered by the Regulatory Settlement?

A. No. The capital expenditure commitments have, however, been clarified. Section 2.1 in the 2008 Agreement contains the annual capital expenditure requirements for each of the five years after the Closing Date. Section 2.1.4 allows FairPoint to credit capital expenditures in excess of the annual minimum requirement in the next year. Effectively, as long as FairPoint spends the minimum agreed to ($52 million in each of the first three years and $49 million in the fourth and fifth year) the commitment is for a cumulative amount over five years. The total capital expenditure commitment, over five years, is therefore, $254 million. FairPoint spent more than the required amount in the first year (April 2008 through March 2009) and spent in excess of $52 million in calendar year 2009.

Section 3.4 of the 2008 Agreement identifies FairPoint's commitment to spend $56.4 million on broadband deployment, which is not entirely incremental to the annual capital expenditure requirement. In DT 07-011 FairPoint pledged to spend $16.4 million on broadband deployment in the first two years, which was incremental to its annual capital expenditure commitment. During negotiations in DT 07-011, FairPoint agreed to spend an additional $15 million over 5 years on broadband deployment, which is also incremental to the capital expenditure commitment. The remaining $25 million, or $5 million in each of the five years following the Closing Date, was included in the annual capital expenditure commitment. Accordingly, $31.4 million of the $56.4 million is incremental to the cumulative capital expenditure commitment, bringing the total capital expenditure commitment for annual capital expenditures and incremental broadband expenditures to $285.4 million over five years. Section 2.5.2 in the Regulatory Settlement clarifies that the commitment to spend $285.4 million in New Hampshire, by April 1, 2013, remains unchanged.

Q. How does the Regulatory Settlement address FairPoint's commitment to spend an additional $65 million by December 31, 2012?

A. Section 2.5.3 of the 2008 Agreement required FairPoint to spend $50 million in excess of the $285.4 million, on projects proposed by FairPoint and approved as the Commission determined appropriate. On May 12, 2009, the Commission approved FairPoint's request to use the $50 million for general working capital conditioned on FairPoint's commitment to invest additional funds on Commission approved New Hampshire projects totaling $65 million by December 31, 2012 (in the Regulatory Settlement this amount is referred to as "other expenditure commitment" or OEC). The Regulatory Settlement preserves FairPoint's OEC but extends the date by which the money must be spent to December 31, 2015. The OEC stems from $50 million Verizon contributed pursuant to section 2.5.2 of the 2008 Agreement, which was intended as assurance that the legacy network was adequate to allow FairPoint to fulfill its broadband and service quality commitments with the capital expenditure assumptions in FairPoint's cost model in DT 07-011, or to be used to advance broadband beyond what FairPoint had committed. The legacy network was not what FairPoint expected, and from the Closing Date through the end of 2009, FairPoint installed much more interoffice fiber in New Hampshire than it initially planned. As a matter of compromise, the Staff Advocates agreed to credit $4.5

million of the OEC as having already been spent in excess of what was planned for New Hampshire capital expenditures.

The 2008 Agreement required FairPoint to achieve 95% broadband availability. Prior to the Closing Date, FairPoint anticipated it would cost, and committed to spend at least, $56.4 million to achieve 95% availability. However, the 2008 Agreement required FairPoint to achieve 95% availability irrespective of the cost. FairPoint now estimates it will cost an additional $10.5 million to achieve 95% availability. The Staff Advocates agreed to allow FairPoint to use up to $10.5 million of the assurance money, now $65 million OEC, in the event FairPoint ultimately invests an additional $10.5 million in capital expenditures to achieve 95% broadband availability.

Q. **Please explain why Section 2.5.4 of the Regulatory Settlement proposes to reallocate $10 million of the OEC to recurring maintenance capital.**

A. The sum total of the cumulative capital expenditures for recurring maintenance and broadband deployment, required by both agreements, is $285.4 million. FairPoint spent $157.6 million in New Hampshire from the Closing Date through the end of 2009. FairPoint estimates it will require a significant amount of the remaining $127.8 million to complete broadband deployment, which may result in inadequate recurring capital expenditures for 2010, 2011, 2012 and the first quarter of 2013. The Regulatory Agreement proposes to reallocate $10 million from the OEC that would be spent on special projects, to recurring maintenance, bringing the cumulative total required capital expenditure to $295.4 million.

Q. **Assuming FairPoint spends the additional $10.5 million on broadband deployment, and $10 million is spent on future recurring maintenance, what does the Regulatory Settlement propose to do with the remaining $40 million of the OEC?**

A. Section 2.5.3 of the 2008 Agreement specifies that FairPoint propose a plan, for Commission approval, on how it would spend the $50 million contributed by Verizon. Attachment 2 of the Regulatory Settlement identifies projects in which FairPoint would be allowed to invest the remaining OEC, without additional approval by the Commission. These projects must enhance the New Hampshire network and would be in addition to anything required to achieve 95% broadband availability. Pre-approved network enhancing projects would include expansion of fiber to customer premises; deployment of fiber to increase capacity; deployment of soft switches, likely to be the next generation of central office switching; and network enhancements necessary to develop video, voice over internet protocol or carrier Ethernet services.

Q. In what ways does the Regulatory Settlement modify the financial conditions required under the 2008 Agreement?

A. Section 2 of the 2008 Agreement contained financial conditions which required FairPoint to reduce its dividend after the Closing Date, restricted FairPoint from paying dividends if its leverage ratio or interest coverage ratio approached violation of certain covenants in its Credit Agreement, required excess cash to be used to pay down debt, and provided an opportunity to terminate the financial conditions. Section 2 also specified capital expenditure requirements, working capital adjustments between Verizon and FairPoint at the Close of the transfer between them, use of the $50 million contributed by Verizon, and a process for Commission review of the 2008 final credit agreement and loan documents. Some of these financial conditions have been satisfied and others are rendered moot by the terms of the new loan documents. Consequently, the financial conditions in Section 2 of the 2008 Agreement have been replaced by conditions in the Regulatory Settlement.

Q. Please briefly describe how the Regulatory Settlement addresses the management of FairPoint.

A. As part of the bankruptcy reorganization most creditors will have their claims satisfied with equity interests in the reorganized company, thus becoming the company's owners. The new owners will appoint a new Board of Directors consisting of a supermajority of newly appointed independent directors. The Regulatory Settlement requires FairPoint to appoint a regulatory subcommittee in its Board of Directors, which will monitor compliance with regulatory requirements. Either the Lead Director or the Independent Chair of the Board will be available to meet with Staff or the Commission, if appropriate, to discuss regulatory concerns. At least one member of the Board of Directors will reside in Maine, New Hampshire or Vermont. Section 4.8 of the Regulatory Settlement prohibits FairPoint from paying dividends for a period of two years following emergence from bankruptcy, if FairPoint is in breach of any of the material terms of the Regulatory Settlement. The Regulatory Settlement also contains terms intended to insure the new owners and Board of Directors will require management to focus not only on the financial success of the company but also on service quality. Section 4.6 in the Regulatory Settlement requires that management bonuses be based on a combination of service quality goals and financial performance.

FairPoint is augmenting its executive management team. FairPoint has hired an interim Chief Information Officer and Section 4.1 of the Regulatory Settlement represents that FairPoint will recruit a permanent Chief Information Officer. In addition, FairPoint hired a Chief Strategy Officer and has appointed and agreed to maintain state presidents in Maine, New Hampshire and Vermont to provide a senior regulatory presence in each state.

Q. Would you please summarize your testimony?

A. The events that have followed the Commission's approval of the transfer of Verizon's assets to FairPoint have been very disappointing. However, FairPoint's plan for reorganization will provide FairPoint another opportunity to complete the commitments it made to the State of New Hampshire. The Regulatory Settlement preserves FairPoint's capital expenditure commitments, its broadband deployment commitments and its quality of service commitments and leaves unchanged its commitments to wholesale providers. For these reasons, based on the information available to me, I recommend the Commission approve the Regulatory Settlement and the change of control.

Q. Does this conclude your testimony?

A. Yes.

KATHRYN M. BAILEY, P.E.

New Hampshire Public Utilities Commission
Director of Telecommunications

Kate Bailey is a telecommunications regulatory specialist with over 20 years experience in the regulation of incumbent and competitive wireline telephone companies. She is a licensed professional engineer. Kate started with the Commission as a Telephone Utility Engineer and has been promoted through the years to her current position as Director of Telecommunications. Prior to her career at the Commission, Kate was commissioned in the United States Air Force and worked as a communications officer performing system testing on airport radar and digital microwave radios.

As Director of the Telecommunications Division, Kate manages the regulatory oversight of all incumbent and competitive telecommunications companies authorized in the state. Kate has advised the Commission on major policy decisions and directs staff from all disciplines on telecommunications issues. She has supervised the production of and sponsored expert testimony before the Commission on numerous occasions. Most recently Kate testified on the 2008 Agreement in Docket No. DT 07-011; *Transfer of Verizon Assets and Franchise to FairPoint.*

EXPERIENCE

New Hampshire Public Utilities Commission (2002 to Present)
Director, Telecommunications

New Hampshire Public Utilities Commission (2001)
Chief Engineer

New Hampshire Public Utilities Commission (1997-2001)
Assistant Chief Engineer

New Hampshire Public Utilities Commission (1989-1997)
Telephone Utility Engineer

TRW and CEA Federal Contracts (1987-1988)
Assistant Program Manager for Digital European Backbone

United States Air Force 1983-1987
Communications Officer

EDUCATION

UNION COLLEGE, Schenectady, NY, B.S. Electrical Engineering, 1983

National Association of Regulatory Utility Commissioners Regulatory Studies Program 1989

New Hampshire Certified Public Managers Program 1998

LICENSED PROFESSIONAL ENGINEER August 1991-Present, New Hampshire License No. 8228