STATE OF NEW HAMPSHIRE

BEFORE THE

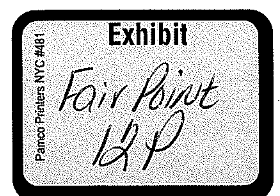
PUBLIC UTILITIES COMMISSION

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.**

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

September 10, 2007



Summary: Mr. Balhoff's testimony provides further detail and clarification on his direct testimony regarding financial data and industry forces and responds to the testimonies of the New Hampshire Office of Consumer Advocate (OCA) and Labor Intervenors' witnesses as offered in New Hampshire Public Utilities Commission Docket DT 07-011 (this Docket). Mr. Balhoff discusses four principal issues: disinvestment versus investment themes; allocation of risks in the transaction; the sensitivity analysis related to cash flows in 2012 contained in his direct examination; and certain relevant insights about the capital markets today.

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1 ## Introduction

2 Q. Please state your name.

3 A. Michael J. Balhoff.

4 Q. Are you the same Michael Balhoff who previously filed testimony on behalf of
5 FairPoint in this proceeding?

6 A. Yes.

7 Q. What is the purpose of your testimony?

8 A. I am responding to the reply testimonies provided by the experts employed by
9 OCA, Labor Intervenors and other Intervenors regarding the financial testimony
10 in this Docket. More specifically, I am clarifying certain questions that arose
11 concerning my direct testimony, correcting the record regarding certain
12 misunderstandings of Intervenors and others about the financial data in this
13 proceeding, providing the necessary context concerning the industry forces that
14 affect the investment ratios, and responding to Intervenors' comments related to
15 capital markets issues.

16 Q. Which parties have commented upon financial data in this Docket?

1 A. Mr. David Brevitz and Ms. Susan M. Baldwin provided testimony on behalf of
2 the New Hampshire Office of Consumer Advocate; Mr. Randy Barber and Dr.
3 Kenneth R. Peres provided testimony on behalf of the Labor Intervenors. The
4 Staff of the New Hampshire Public Utilities Commission (the Commission)
5 engaged Liberty Consulting to provide advice and testimony in this proceeding.
6 Liberty Consulting provided the testimonies of Mr. John Antonuk, Mr. Randall E.
7 Vickroy, Mr. Robert V. Falcone and Mr. Charles H. King. Several other
8 Intervenors provided testimony on behalf of other carriers. My testimony
9 responds to the financially-based questions posed especially by Mr. Brevitz, Mr.
10 Antonuk, Mr. Vickroy and Mr. Barber.

11 **Summary Overview**

12 Q. Please summarize your testimony.

13 A. I affirm four general insights.

14 • **FairPoint is committing to investment in the Northern New England**
15 **("NNE") region, not "disinvestment" as alleged by Mr. Barber.** First,
16 based on my years as a financial telecommunications industry analyst, I
17 will explain the fallacies in the "disinvestment theme" and in the
18 commentary about the "unsustainability of the FairPoint business model,"
19 both issues raised by Mr. Barber on behalf of the Labor Intervenors. I will

1 also provide additional support for FairPoint's statement that it intends to
2 invest "more" in the network on behalf of customers. With respect to the
3 data used to support the Labor Intervenors' projections regarding
4 "disinvestment," I will show that the ratios (capital expenditures as a
5 percentage of depreciation) and per-unit investments cited as problematic
6 by the Labor Intervenors are at a minimum consistent with the statistics
7 drawn from other independent local exchange companies in the industry.
8 The data used by Mr. Barber are explained by industry and financial
9 changes affecting all carriers in the local exchange business and do not
10 signal an anti-investment strategy by FairPoint. I will affirm that the
11 fundamentals—line growth, minutes of use, product bundles, capital
12 expenditures, etc.—are evidence of changes being experienced across the
13 industry, and I note that virtually all the companies in the local exchange
14 carrier industry are undergoing change. As a result, the competitive
15 models, operating trends, and capital structures are not the same as they
16 were even a decade ago. However, it is my opinion that FairPoint's
17 modeling and approach are appropriate responses to the evolving
18 marketplace and are consistent with the investments being made by other
19 comparable local exchange carriers. With respect to FairPoint's intention
20 to invest, I repeat my conviction that FairPoint's incentives and the other

1 stakeholders' goals are properly aligned so that investment will occur
2 rapidly.

3 • **FairPoint is appropriately allocating risk.** Second, I will comment on
4 the "risks" that exist in the marketplace today. The fear, articulated
5 especially by Mr. Barber, is that the risks are not properly allocated and
6 that customers and employees are likely to suffer before shareholders. I
7 will not equivocate—Mr. Barber's assertion is incorrect. Equityholders, in
8 terms of the underlying valuation of their stock and in terms of their
9 access to dividends, bear the near-term and longer-term risk; and
10 appropriate systems are in place to give policymakers confidence that this
11 is the case. Notably, FairPoint is modeling approximately $142 million in
12 annual equity dividends that can and will be reassigned to the business if
13 there is any need to reallocate that capital. FairPoint has affirmed this in
14 its public statements about its dividend policy and priorities and in its
15 testimony in this proceeding. FairPoint has stated that it intends to meet
16 its operating expenses which include wages and benefits for employees, to
17 make capital expenditures appropriate to its business and to pay principal
18 and interest on its debt before paying dividends. No facts have been
19 advanced to show any basis to conclude that FairPoint has not done this in
20 the past and will not do so in the future.

1 • **My sensitivity analysis related to cash flows in 2012 accounts for an**
2 **appropriate level of absolute growth in total cash expenses and an**
3 **even higher level of per-unit growth compared with direct costs that**
4 **have been *declining* in the Verizon northern New England (NNE)**
5 **region.** The Labor Intervenors have raised questions about the sensitivity
6 analysis that I presented in my direct testimony, and have suggested that it
7 was a helpful analysis but that it should have included costs that rose more
8 sharply. Further, there were suggestions that very modest changes in that
9 model illustrate that FairPoint has little room for error. I will clarify the
10 rationale for the input variables that I employed, why modest changes in
11 the analysis are not significant, and how FairPoint's executives will
12 manage positive or negative movements that are contained in my analysis.
13 I will also explain that Verizon's direct costs in the region have actually
14 been *contracting* at an annual rate of 1.8%. More fundamentally,
15 FairPoint represents that the very significant cash flow allocated to its
16 dividend can be reallocated, with the simple result that FairPoint has the
17 flexibility to absorb additional costs in the event assumptions prove
18 incorrect. The Intervenors are therefore wrong.

19 • **The capital markets reward outperformance rather than**
20 **underperformance in a strategic acquisition.** Much of the Intervenor

1 based testimony has focused on the longer-term risks, and those
2 Intervenors note their fear that the ultimate outcome will be that the
3 customers will be left with a "distressed utility." My experience as a
4 financial analyst in the local exchange sector leads me to focus on factors
5 that no Intervenor appears to be considering—the potential for
6 outperformance.

7 - **Financial regulation requires focus on risk and avoidance of**
8 **reliance on optimistic scenarios.** First, I note that financial
9 regulators essentially require that companies reporting to investors
10 provide detail on every imaginable risk and tend to discourage
11 presentations of more optimistic scenarios. The models and
12 representations to investors and in the proceedings before this
13 Commission nowhere include an "optimistic scenario" with respect
14 to new products, video services or margin expansion, in spite of
15 the fact that those kinds of outperformance measures in some form
16 or another have unfolded in the majority of BOC divestitures/ILEC
17 acquisitions over the last decade.[4]

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[4] I have studied the Verizon divestitures of local incumbent telephone operations in Texas, New Mexico, Oklahoma, Iowa, Missouri, Kentucky, Arkansas, Wisconsin, and Alabama. To the best of my knowledge, all those acquisitions not only were favorable, but resulted in outperformance by the acquirer. Two of the companies—Iowa Telecom and Valor Telecom—had no real telecommunications team or systems prior to those acquisitions.

1 - **Companies are rewarded when operating expectations can**
2 **outperform equity analysts' models.** Companies with publicly
3 traded stocks are rewarded when they outperform their projected
4 financials, and FairPoint is aware of this market dynamic.
5 Investors prefer that there be a "surprise on the upside" that
6 permits analysts to raise their ratings on the stock. At the same
7 time, companies generally are cautious that they do not inflate
8 expectations, since the stock of public corporations can lose value
9 rapidly due to underperformance. Experienced financial analysts
10 understand this dynamic and typically presume that company
11 announcements are based on reasonable and sometimes
12 conservative projections. Notably, in this case, all the Intervenor
13 testimony has assumed no outperformance and has failed to
14 demonstrate with certainty that the base case will not be achieved,
15 but has instead focused on potential miscues individually and
16 severally on the downside.

17 - **Finally, the credit agencies are waiting to make adjustments to**
18 **their ratings, and the indications are that they will be more**
19 **favorable once the acquisitions are completed.** While
20 FairPoint's debt is likely to be rated BB, which is at the top of the

1 non-investment grade category, I note that such a rating on the
2 company's debt is not a vote of no-confidence, but is simply a
3 reflection of price of the debt. This is not a speculative situation,
4 but reflects a company competing in a changing industry, with
5 some important fundamental elements in decline (including access
6 lines), and with new competitive pressures. The comparisons with
7 Verizon's credit rating are simply incorrect, since Verizon has a
8 vastly different portfolio of business opportunities. There is no
9 merit in comparing FairPoint with Verizon, which is an entirely
10 different company involved in different lines of business than
11 FairPoint. Even today, Verizon has no written, public commitment
12 to use its higher credit rating to assist any of its telephone
13 operating companies, including Verizon New Hampshire.

14 Q. Can you summarize the issues raised by the experts on behalf of the OCA?

15 A. Yes. Mr. Brevitz takes issue with FairPoint's financial status and projections.[1]
16 He focuses on the risks in terms of the amount of debt proposed, the size of
17 FairPoint, the level of FairPoint's dividend obligation, and specific "questions"
18 raised about assumptions in the company's model.

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1 See Direct Testimony of David Brevitz, on behalf of the OCA, Highly Confidential Level 1, p. 8 [hereafter BREVITZ].

1 Q. Can you summarize the financial issues raised by Liberty Consulting's Mr.
2 Antonuk and Mr. Vickroy on behalf of the Commission Staff?

3 A. Yes. Mr. Antonuk states that there is "substantial risk that [FairPoint] will not be
4 able to fund capital and operations requirements while maintaining the high
5 dividend that serves as the cornerstone of its approach for producing shareholder
6 value" (ANTONUK, p. 10). In particular, Mr. Antonuk believes that FairPoint's
7 modeled "synergies" should be excluded as potentially unrealistic and the
8 company should anticipate higher-than-expected transition costs. Mr. Vickroy
9 believes that FairPoint has provided insufficient proof of its projected "synergy"
10 savings (VICKROY, pp. 19-21); and he states that a cutover from Verizon back-
11 office systems to FairPoint systems after five months is overly optimistic and the
12 cost to FairPoint for a period of extended TSA services could prove "devastating"
13 to FairPoint's financial results (VICKROY, p. 21). His analysis suggests a
14 reduction in FairPoint's synergy-based cash flows and a reduction in annual
15 EBITDA to mirror the problems at Hawaiian Telcom (VICKROY, pp. 30-31).

16 Q. Can you summarize the issues raised by Mr. Barber on behalf of the Labor
17 Intervenors?

18 A. Yes. Mr. Barber provides two sets of testimonies—one public (Labor Intervenors
19 Statement Number 2, or BARBER #2) and a confidential statement (Labor

1 Intervenors Statement Number 3, or BARBER #3). He disagrees with the
2 accuracy of FairPoint's financial projections (BARBER #3, p. 2). In short, Mr.
3 Barber contends that FairPoint's model is not reliable and that the company is
4 likely to be distressed over the next eight years, with the result that harm will be
5 borne, in order, by employees, customers, communities/state, shareholders and
6 lenders (BARBER #2, p. 51).

7 **FairPoint's Investment In The Network**

8 Q. The Labor Intervenors have asserted that FairPoint may not invest sufficient
9 amounts in the region and is "disinvesting in its network" (see BARBER #2, p.
10 40; BARBER #3, p. 13). Do you agree?

11 A. No. FairPoint has stated from the date of the announcement of the merger
12 transaction on January 16, 2007, that the company intended to raise the level of
13 investment to significantly expand broadband availability and to achieve a per-
14 line capital investment that is superior to Verizon's non-FiOS per-line investment
15 in the northern New England ("NNE") region. I have included from my initial
16 prefiled testimony a table which tracks total capex. However, Table 1 below
17 includes additional data about 2004 results that were not included in the original
18 table. Those data provide perspective that the absolute Verizon investment, when
19 FiOS investment is excluded, was lower than FairPoint's projected commitment.

1 I firmly contend that the appropriate metric for the comparison should be
2 investment per-line without the FiOS investment (as will be explained further
3 below). I note that Table 1 provides information that shows that non-FiOS per-
4 line investment *rises* from Verizon's recent high point of $98.91 in 2004 to
5 FairPoint's level of $105.48 in 2008 and higher levels every year throughout the
6 remainder of the model.

7 **Table 1: Summary NNE capex, actual (including 2004) and projected**

(in millions)	2004A	2005A	2006A	2007E	2008E	2009E	2010E	2011E	2012E
Total NNE Revenue	$1,200	$1,206	$1,194	$1,177	$1,151	$1,145	$1,150	$1,144	$1,138
Total capex	$182	$203	$214	$186	$296	$138	$134	$130	$128
% of revenue	15.2%	16.8%	17.9%	15.8%	25.7%	12.1%	11.7%	11.4%	11.3%
FiOS	$10.5	$58.2	$66.7	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Non-FiOS capex	$172	$145	$147	$138	$143	$138	$134	$130	$128
% of revenue	14.3%	12.0%	12.3%	11.7%	12.4%	12.1%	11.7%	11.4%	11.3%
$ per avg line	$98.91	$87.58	$94.44	$94.66	$105.48	$108.26	$110.87	$112.00	$114.58
EOY sw. access lines	1,696	1,608	1,507	1,399	1,312	1,241	1,184	1,138	1,099
Avg sw. access lines	1,739	1,652	1,557	1,453	1,355	1,276	1,213	1,161	1,119

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9

10 To clarify further, three factors should be understood when comparing FairPoint's
11 projected capex to the historical capex from 2004 through 2006. First, the
12 number of access lines in service continues to decline, which means that one
13 would expect total maintenance as well as new plant commitments to decline
14 compared with the total investment in previous periods (including a decade ago
15 when there was growth in units from one year to the next). ***BEGIN
16 CONFIDENTIAL INFORMATION***

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3 ***<u>**END**</u>

4 <u>**CONFIDENTIAL INFORMATION**</u>*** Third, the per-line investment using

5 non-FiOS investment should include only switched access lines since the addition

6 of other connections—DSL lines and UNE-L lines—in analyzing per-line

7 investment can distort the comparative analysis. Specifically, DSL lines in the

8 NNE region are not "naked DSL" lines and would result in double-counting if

9 included, with the result that the investment per-line would be incorrectly

10 represented as diluted. Further, the addition of UNE-L lines would be misleading

11 because the incumbent is not responsible for all the capital expenditures

12 associated with provisioning service.

13 Q. How do you respond to Mr. Barber who argues (BARBER #3, pp. 18-19) that

14 UNE-L lines should be included in the denominator to calculate new capex per

15 line?

16 A. In the case of UNE-Ls, the incremental non-loop capital expenditures are borne

17 by the CLEC (competitive local exchange carrier) in question. As a result, a

18 calculation that includes UNE-Ls in the denominator understates the per-line total

19 investment that benefits customers. I believe that the way in which I have

20 calculated capex per line—without UNE-L lines—renders a more accurate picture

1 of the comparative investment patterns that benefit customers. Again, my view is
2 that capex per line—to benefit consumers—is most appropriately computed
3 without UNE-Ls and DSL lines, and that the FairPoint investment per-line is
4 higher than is the recent non-FiOS per-line investment by Verizon.

5 Q. Turning to the question of FiOS, should all of Verizon's capital expenditures be
6 included in the analysis since the region benefits from the FiOS investment?

7 A. No. The relevant issue is "productive investment," that is, capital invested to
8 benefit some statistically significant number of consumers. *****BEGIN**
9 **CONFIDENTIAL INFORMATION*****
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12
13 *****END CONFIDENTIAL INFORMATION***** The to-date FiOS
14 investment is inconsequential in benefiting the region, or worse, it is distorting the
15 analysis. Additionally, the table highlights a more sobering investment insight,
16 which is that per-line FiOS investment is at levels that are unsustainable for the
17 broader region. *****BEGIN CONFIDENTIAL INFORMATION*****
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20

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2 ***<u>END CONFIDENTIAL</u>

3 <u>INFORMATION</u>*** In short, I believe that the FiOS capital expenditures are

4 not appropriate for investment comparison purposes from the pre- and post-

5 Verizon periods because the inclusion of the former FiOS investment distorts the

6 analysis of "productive investment."

7 ***<u>BEGIN CONFIDENTIAL INFORMATION</u>***

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12 ***<u>END CONFIDENTIAL INFORMATION</u>***

1 My opinion is that investment in copper-based plant, supplemented by fiber routes
2 and inter-office facilities where economically feasible, in NNE will benefit more
3 subscribers in the region and is the appropriate metric for comparing investment
4 levels between the Verizon and the FairPoint time periods. Further, my firm
5 belief is that per-line metrics are the appropriate measure of the company's
6 regional investment in a marketplace with declining numbers of lines. I reaffirm
7 that FairPoint is projecting per-line investment that continues to rise to benefit a
8 larger proportion of the customer base using a platform that can be migrated to
9 higher speeds, depending on electronics and loop length as explained by Dr. Doug
10 Sicker.

11 Q. Mr. Barber has provided testimony that FairPoint is pursuing a strategy to
12 generate high dividends based on low reinvestment levels (BARBER # 2, p. 7;
13 BARBER #3, pp. 15-16). He argues that a condition should be imposed that
14 essentially forces FairPoint to spend on capital expenditures at levels equal to
15 100% of depreciation (BARBER #2, p. 56). Is Mr. Barber correct?

16 A. No, he is not correct, and the proposed condition would be inconsistent with
17 industry trends. While Mr. Barber correctly states that FairPoint plans to reinvest
18 only "about two-thirds of the amount it recovers in depreciation" (BARBER #2,
19 p. 40), he incorrectly concludes that the level of capital investment is short of the

1 appropriate levels of reinvestment (BARBER #2, p. 24).[5] In fact, his proposal
2 that FairPoint should retain an amount equal to 100% of depreciation suggests
3 that Mr. Barber does not understand that capital expenditures across the local
4 exchange carrier industry do not match depreciation expense dollar-for-dollar
5 today and is a backwards-looking measure that is inappropriate when planning
6 future investments. An analysis of virtually all the industry-comparables reveals
7 that FairPoint's plans are in line with those levels. In short, it is not
8 underinvestment that FairPoint is modeling but it is a level consistent with
9 industry trends.

10 First, I review the data and then consider the appropriate interpretation. With
11 respect to the data drawn from other companies in the industry, I note that
12 Verizon was the <u>only</u> major local carrier whose capex slightly exceeded its
13 depreciation in 2006, significantly because of FiOS (which might be estimated to
14 have been $3 billion to $4.5 billion out of a total capital outlay of $17.1 billion in
15 2006, of which $8.66 billion was for non-MCI wireline assets). By contrast, even
16 the largest carrier in the industry, AT&T, had capex in 2006 that was 84% of its
17 full-year depreciation (even while expanding its fiber-to-the-node systems and
18 investing significantly in wireless), while <u>all</u> the major rural carriers had capex

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5 Barber, Confidential Testimony, p. 16; Mr. Barber states that "FairPoint is proposing to siphon cash out of Northern New England—cash it collects from customers for depreciation to be reinvested in its network . . ." The commentary is incorrect, as depreciation is a non-cash expense item for capital expenditures *that have already been incurred.*

1 well short of depreciation levels.[6] Table 3 summarizes the rural carrier (guideline
2 company) data based on 2006 annual reports and compares the figures with
3 FairPoint's projections for FRP NNE for 2009. I note that I prepared my
4 calculations based on capex divided by end-of-year switched access lines,
5 whereas Mr. William King used averaged lines, but our figures are very close.

6 **Table 2: Rural LEC 2006 capital expenditures per line and as a percentage of depreciation**

	Capex / line	Capex / depreciation
Alaska Communications [1]	NM	88.0%
CenturyTel [2]	NM	60.0%
Citizens	$105.89	56.4%
Consolidated	$144.03	47.2%
Embarq	$135.00	89.9%
FairPoint	$128.80	58.4%
Iowa Telecom	$111.86	58.2%
Windstream	$116.45	83.1%
Median	**$122.63**	**59.2%**
FairPoint/NNE 2009 pro forma [3]	**$108.26**	**55.4%**
FairPoint/NNE 2009 pro forma [4] w/o FiOS	**$108.26**	**58.5%**

[1] ACS capex includes wireless and non-ILEC investments, making per-line figures not comparable.
[2] CenturyTel capital expenditures include dedicated long-haul and intermediate-haul fiber.
[3] Spinco-only capex/line (standalone FRP has no 2009 line estimates; capex/deprec is modeled combined operations.
7 [4] Excluding estimated FiOS deprec. of $15.75 million from 2009 total; also same as note [3] above.

8 The table highlights that FairPoint's expectations are consistent with *industry*
9 *trends* rather than being the result of some strategic plan by FairPoint to
10 underinvest. In fact, in 2006, the median capex-to-depreciation depicted in the
11 table was about 59%. FairPoint's capex to fully-loaded depreciation is expected

[6] See AT&T SEC filing in its 10K; 2006 capital expenditures were $8.3 billion while depreciation was $9.9 billion; available at http://www.sec.gov/Archives/edgar/data/732717/000073271707000015/ex13.htm.

1 to be close to that figure as it is estimated to be 55.4%. ***<u>**BEGIN**</u>
2 <u>**CONFIDENTIAL INFORMATION**</u>***
3
4 ***<u>**END**</u>
5 <u>**CONFIDENTIAL INFORMATION**</u>*** Excluding the estimated FiOS
6 depreciation produces a comparison figure of 58.5%.

7 Q. What is the reason that capital expenditures are falling short of the historic levels
8 of depreciation?

9 A. The explanation is, in part, due to the fact that the number of access lines is
10 shrinking and capital expenditures in earlier years were accommodating line
11 growth that was 3%–5% (in the 1980s and 1990s). Growth is not occurring as it
12 once did, and some plant can be redeployed. A second and important factor is
13 that electronics prices are falling, which means that replacement technologies are
14 less expensive and more efficient.[7] Because of these factors, the data reveal that
15 FairPoint's projected levels of capital investment are consistent with those across
16 the industry.

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[7] Several clarifications about the table are provided in the footnotes, including additional insight into the relatively higher capital expenditures for particular carriers. Alaska Communications Systems has significant other commitments, which are not segregated in its reporting, including wireless operations, and CenturyTel has major fiber transport businesses in the Midwest and more recently in the Southeastern U.S. Those other investments distort the capex per-line figures, which is the reason I use median values to summarize instead of using averages.

1 Q. Why do you present 2009 figures for FRP NNE, and doesn't the table highlight
2 that FairPoint will invest less per line than the other carriers at least based on
3 2006 data?

4 A. I included 2009 pro forma figures to base my calculations on the first year in
5 which FairPoint will have "normalized" numbers, as 2008 is expected to include
6 extraordinary investments which raise the per-line level of investment. With
7 respect to the levels of FairPoint's investment per-line, it is important to note that
8 per-line investments typically vary from company to company and from one
9 region to another. Various factors contribute to the differences, including size of
10 the company, "lumpy" levels of investment from one year to the next,
11 characteristics of the weather and terrain in the service region, and density of the
12 markets served by the carriers. A carrier serving a very rural region would have
13 higher per-line investment, all else being equal. FairPoint (pre-combination with
14 Verizon) and CenturyTel serve relatively more rural regions (lesser density), for
15 example, than the regions that Windstream or Verizon serve on average. Further,
16 it might be noted that the figures per-line for FairPoint NNE ($108.26 in 2009)
17 are not appreciably different from Citizens ($105.29 in 2006), which has a high
18 concentration of lines in Rochester and in northern New York balanced by very
19 rural regions elsewhere. Finally, as noted earlier in Table 1, FairPoint anticipates
20 even higher capex per-line in the later years as the modeled investment per-line

1 rises to $115 in 2012 and $123 in 2015 (the last estimate is in the model, but is
2 not included in the table). In short, the industry data refute the contention that
3 FairPoint intends to underinvest. In fact, FairPoint's projected levels of
4 investment are entirely consistent with industry patterns today.

5 Q. What about Mr. Barber's contention that FairPoint's strategy involves
6 underinvesting expressly to pay high dividends (BARBER #2, p. 24)?

7 A. He is incorrect. As discussed above, FairPoint is not underinvesting. Mr. Barber
8 apparently has assumed, since he has produced no other analyses or
9 methodologies, that appropriate levels of capital expenditures would result in
10 capex *matching* depreciation levels. Consistent with this view, Mr. Barber
11 suggests a condition that "the cumulative dividend NNE can declare in any year
12 may not exceed the difference between that year's earnings (income or loss)
13 before interest, taxes, depreciation, and amortization (EBITDA) and 100% of its
14 depreciation expense. This restriction will require that an amount of cash, equal to
15 100% of that year's depreciation expense, will be available for NNE's capital
16 expenditures." (See BARBER #2, p. 56). However, this analysis suggests that in
17 2009, the capital expenditures per line should be approximately $195 using the
18 data from Table 3. The figure is of course substantially higher than any
19 investment levels per line at any other carrier, as is apparent in the table, and it is
20 higher than the average investment by Verizon *even before excluding* the costly

1 fiber-to-the-premises upgrade. Mr. Barber's condition would result in an
2 unprecedented constraint that limits use of the company's cash in an increasingly
3 competitive business based on a methodology that produces results materially
4 different from industry practices.

5 Q. Why is FairPoint's dividend yield set at high levels?

6 A. There are several answers. With respect to the level of the dividend yield,
7 FairPoint's current yield (August 10, 2007) is 9.9%. In fact, the stock prices of
8 the entire group of publicly-traded ILECs have fallen, driving up the dividend
9 yields since the beginning of July 2007. Obviously, as the stock price goes
10 down—due to market conditions, recent earnings, and/or uncertainties about the
11 industry—the dividend can remain the same but the yield (dividend divided by the
12 stock price) rises. The second insight about higher-yielding telecommunications
13 securities is that investors require an appropriate return on their investment, and
14 those returns are generated by a combination of capital appreciation and dividend
15 payments. Mr. Barber suggests (BARBER #2, p. 39), but fails to demonstrate,
16 that FairPoint uses its dividend to "pump up" the stock price. In fact, the markets
17 assess information efficiently and set prices for shares more significantly in light
18 of the outlook for cash generated—retained by the company or paid out. More to
19 the point, shareholders require certain competitive levels of returns on capital, and
20 those returns are generated from the combination of (1) appreciation and (2)

1 dividends. If a business is expanding sharply, dividends will be low or non-
2 existent because investors expect to generate the majority or all of the return from
3 appreciation in the stock price, which is driven by rising cash flows and/or higher
4 earnings per share. If a business' fundamentals are flat or declining, capital
5 appreciation is expected to be relatively low or non-existent, meaning that a
6 holder of equities will seek a higher dividend payment. These are the simple
7 realities of the equity markets. FairPoint and its peer companies are paying
8 relatively higher dividends precisely because fundamental growth (hence capital
9 appreciation) is harder to generate than it was in the past. In this case, *if*
10 *policymakers expect FairPoint or any carrier to maintain some appropriate*
11 *market-responsive balance between debt and equity, they will have to permit*
12 *appropriate returns for holders of debt securities and equity securities.* Total
13 return considerations drive the markets' pricing of equity, which is critical in
14 running a capital-intensive business. The level of the dividend yield reflects the
15 market's return-requirements in the face of a more competitive marketplace,
16 changing technologies, and lesser opportunity to generate capital appreciation.
17 Equity investors understand that the ultimate risk is borne by those who hold
18 shares in the companies. Again, as I noted in my prefiled testimony, FairPoint's
19 projected $142 million in dividends can be reduced and provides a buffer for the
20 company in the unlikely event FairPoint were to fall short of its projections.

1 Q. Mr. Barber stated that FairPoint is paying an artificially inflated dividend,
2 allegedly to support the company's stock price as currency for acquiring other
3 companies, using "depreciation-derived cash flows." (BARBER #2, p. 39).
4 Please comment.

5 A. I will make several points. First, depreciation is a non-cash expense, which is
6 backed out of net income to calculate cash flow. Importantly, the cash
7 expenditure associated with depreciation has already occurred in the past and no
8 cash is generated by depreciation (contrary to the assertion by Mr. Barber.)
9 Second, while FairPoint has been clear that the company strategically is
10 committed to acquisitions, before this proposed combination with Verizon's
11 assets, FairPoint has not used its stock as currency and the company has in fact
12 financed its earlier acquisitions through debt and/or cash. Third, Verizon is not
13 investing cash in amounts equal to depreciation or maintaining cash on its NNE
14 balance sheet (first quarter cash in 2007 was $42 million), as the company is
15 using its free cash flow for other purposes (dividends, debt repayment, etc.),
16 which is not appreciably different from FairPoint's intention to use excess cash
17 for debt repayments or capital costs or other business-related purposes and then
18 for dividends. Fourth and more fundamentally, FairPoint's dividend payments are
19 not inflated but are within a range required by the equities markets. Table 4
20 provides a valuable perspective on this important insight, illustrating rural

1 carriers' operating cash in 2006 divided by ongoing dividend payments in 2006
2 (note that I excluded the special dividends of $2.3 billion paid by Windstream to
3 Alltel). Further, the table provides free cash flow for each carrier (defined as
4 operating cash drawn from the cash flow statement less capex) divided by
5 dividends paid. The table highlights that one carrier—CenturyTel—has a very
6 small dividend ($0.26 or about 0.6% per share on August 7, 2007), but all the
7 others pay a more significant dividend. On a pro forma basis, FairPoint's
8 operating cash and free cash flow before dividends as percentages of actual
9 dividends compare favorably with the industry comparables (guideline
10 companies), showing that FairPoint is responding to market-driven requirements
11 for returns rather than "artificially inflating" its payout. I note that the companies
12 in the table are the true comparables in terms of underlying operations, size of
13 operations, and kinds of services provided. Citizens Communications, in
14 particular, has metrics that are very close to the pro forma figures for
15 FairPoint/NNE. While Mr. Barber alleges that FairPoint is paying a "high
16 dividend [that] *pumps up* its stock price" [emphasis added] (BARBER #2, p. 39),
17 the data verify that the pro forma FairPoint/NNE statistics are within the ranges of
18 other effective and viable large and independent carriers. Further, the dividend
19 policy is consistent across the entire group (with the exception of CenturyTel),
20 reflecting equity investors' expectations and requirements for market-based
21 returns. I note that, while the FRP/NNE figure for FCF before dividends

1 (157.9%) on a pro forma basis is slightly below the group's median (178.6%), the
2 FRP/NNE figure is depressed due to FairPoint's commitment to invest capex
3 (included in the FCF statistic) in its northern New England properties. Also, after
4 excluding CenturyTel from the final column (CenturyTel's very low dividend
5 payment makes it a statistical outlier), the pro forma FRP/NNE figure is above the
6 revised median (149.5%).

7 **Table 3: Operating cash and free cash flow before dividends divided by dividends**
8

	Operating cash / dividends	FCF before divs / dividends
Alaska Communications Systems	255.8%	86.0%
CenturyTel	2878.9%	1803.4%
Citizens	261.7%	178.6%
Consolidated	189.7%	114.8%
Embarq	596.8%	328.5%
Iowa Telecom	175.5%	120.4%
Windstream [1]	1101.0%	735.2%
Median	**261.7%**	**178.6%**
Median without CenturyTel	**258.7%**	**149.5%**
FairPoint/NNE 2009 pro forma	**276.1%**	**157.9%**

9 [1] Windstream dividends in 2006 exclude special and other dividends of $2.3 billion to Alltel.

10 Source: Company financials for 2006; FairPoint NNE model.

11 Q. Mr. Barber alleges that FairPoint's business plan will "destroy all shareholder
12 equity (and hundreds of millions of dollar[s] more) by pursuing its high-risk, high
13 dividend/low reinvestment strategy." (BARBER #3, p. 15.) Is Mr. Barber
14 correct that FairPoint is "cannibalizing itself by continually paying out more in
15 dividends than [FairPoint] earns?" (BARBER #2, p. 6.)

1 A. No. Mr. Barber does not assess the free cash flows and continues to rely upon an
2 analysis of FairPoint's equity account, which is an accounting convention
3 intended to approximate the underlying value of a company after subtracting
4 liabilities. Moreover, Mr. Barber never shows how his unsupported allegations
5 relate to the PUC's consideration of the "public good. " Also, in many situations,
6 including this one, the book equity account is not an indicator of the residual
7 value of the company. In this case, the equity account is appreciably lower than it
8 might otherwise be, due to the accounting conventions that apply to the merger,
9 whereby the value of FairPoint is marked to market, but there is no such
10 adjustment for the Verizon NNE assets. Thus, book equity is one metric but has
11 limitations in capturing true economic value. By contrast, I believe that market
12 capitalization (number of shares outstanding times market price per share) is a
13 more reliable indicator of the cash-generating value of the assets and the longer-
14 term viability of a company. To highlight the contrast between book equity
15 valuations and market capitalization, which is the equity markets' assignment of
16 value, I provide Table 5. In the table, I present the comparable or guideline
17 companies with selected balance sheet items as of the end of the first calendar
18 quarter of 2007 (the most current financial profile for the entire group). Notably,
19 as of the end of the first quarter of 2007, the book equity accounts of Alaska
20 Communications (a deficit of $28.9 million) and Embarq Corp. (a deficit of
21 $331.0 million) were negative in spite of the fact that there is real value in those

1 companies as reflected in the public equity markets, which value the shares of
2 those companies at much higher levels—$585 million and $9 billion, respectively.
3 The market capitalization of the stocks of each of the companies as of the market
4 close on August 7 (using first quarter balance sheet data) is included in the
5 second-to-last column, while the multiple of market cap to book equity is
6 reflected in the final column. Interestingly, the median value of market cap is
7 about 3.0x greater than the book equity account for the peer group, which notably
8 excludes Alaska and Embarq, again since those equity accounts were negative
9 (making it impossible to calculate the ratio). The discrepancy between
10 equityholders' valuations and accounting values is striking. If we were to impute
11 FairPoint's market cap to book equity, it might be 4.8x (approximately 89 million
12 shares times the FRP August 7 price of $15.02 per share), suggesting again that
13 there is far more value in the enterprise in the estimation of the equity markets by
14 comparison with book equity calculations. I have little question about which
15 valuations are more efficient, as the equity markets attempt moment-by-moment
16 to assess risk, cash flows, and long-term prospects.

1 **Table 5: Market capitalization and balance sheet perspectives on industry comparables**
2

	Balance Sheet 1Q07 ($000)						
	Book equity	Equity change 4Q06-1Q07	Net tangible assets	Long-term debt	LT debt to equity	Market cap ($000)	Market cap/book equity
Alaska Communications	(28,946)	(4,257)	(88,953)	436,837	NM	584,767	NM
CenturyTel	3,127,230	(63,721)	(303,906)	2,916,511	0.9	5,000,797	1.6
Citizens	1,316,442	258,410	(2,072,476)	4,755,148	3.6	4,462,562	3.4
Consolidated	108,788	(6,170)	(328,576)	594,000	5.5	461,191	4.2
Embarq	(331,000)	137,000	(358,000)	6,058,000	NM	9,049,362	NM
FairPoint	209,671	(15,048)	(289,521)	616,932	2.9	529,316	2.5
Iowa Telecom	264,645	(3,054)	(238,950)	477,778	1.8	609,481	2.3
Windstream	460,100	(9,700)	(2,593,700)	5,449,100	11.8	6,709,168	14.6
Median					**3.3**		**3.0**
FRP/NNE 2009 pro forma		**NA**	**NA**	**2,485,000**			

3
4

5 Source: Company data 2006 and FairPoint/NNE model.

6 Two other columns are also notable. I have included the change in the equity
7 account from the end of the fourth quarter of 2006 to the end of the first quarter of
8 2007 to illustrate what is occurring with this accounting convention. The book
9 shareholders' equity has shrunk in every case except two—Citizens and
10 Embarq—in spite of the fact that investors continue to view the prospects of all
11 the carriers in a generally favorable light. Further, in the case of Citizens, the
12 goodwill account rose in the first quarter by $574 million from the level in the
13 fourth quarter, reflecting the completion of the company's $1.29 billion purchase
14 of Commonwealth Telephone. This means that Citizens effectively declined in
15 book equity value, excluding that goodwill adjustment. Accordingly, only a
16 single "comparable" company had a positive increase in book shareholders'
17 equity (and the account improved again in the second quarter when Embarq's
18 shareholders' equity turned marginally positive). At the same time, the public

1 markets continue to value the underlying assets and business prospects at
2 multiples higher than the level of the book equity. To drive home the same point,
3 I note that Cablevision, a powerful cable operator that has achieved significant
4 success in the New York region, has a market cap of $10 billion (August 7, 2007),
5 but a deficit book equity of $5 billion as of the end of the first quarter of 2007,
6 which shrinks further after eliminating franchise rights and goodwill to a deficit of
7 $7 billion. Comcast Corporation, which is a viable and formidable national
8 competitor, has a market capitalization of $80 billion today and a book equity
9 account of $42 billion at the end of the first quarter; however, after eliminating
10 the company's franchise rights and goodwill, the company's net book value is a
11 deficit of $30 billion. In short, book equity often falls short in capturing
12 underlying value and can fail to provide insight into the viability of a business.
13 The market is very clear that viable competitors can have declining or even
14 negative book equity accounts, but still provide sound underlying cash flows.

15 The second notable column lists net tangible assets. No carrier in the column has
16 a positive value for net tangible assets—in spite of the fact that there is clearly
17 sound fundamental value. Book equity and net assets are not reliable indicators of
18 value in this sector. The real value is calculated on the basis of free cash flows
19 which are reflected in the market capitalizations.

1 Q. Mr. Barber states that "[n]eedless to say, there is a serious question about the
2 sustainability of FairPoint's business model" and he raises a concern about
3 whether "shareholders and lenders will permit FairPoint to destroy all shareholder
4 equity by pursuing its high-risk, high dividend / low reinvestment strategy."
5 (BARBER #3, p. 15.) Please respond.

6 A. The debt and equity markets are very efficient in processing and acting upon
7 information. FairPoint has commitments for the majority of the debt in this
8 transaction and investors bid up the value of the stock January 16, 2007, upon the
9 announcement of the intention to combine FairPoint with the NNE properties. I
10 suggest that institutional investors who control these sources of capital are
11 rigorous in their analyses of the financial outlook. In fact, the most current and
12 best information/assessment regarding the future is leading investors—in debt and
13 equity markets—to commit capital to this potential combination. While the
14 equity and debt markets have weakened over the last two months (rural ILECs are
15 lower by about 12% since June 8, and FRP is off by about 16%) the equity and
16 debt markets have voted with hard cash and their view is, in my opinion,
17 diametrically opposed to that suggested by Mr. Barber. I contend that the
18 combined "expert testimony" of the financial markets can be known by virtue of
19 the capital commitments and the level of the share price (which was represented
20 at the announcement of the transaction and held up until the recent weakness in

1 the sector). Mr. Barber raises false alarms about the sustainability of the model.
2 Lenders have a strong interest in investment and will require ongoing investment
3 before permitting the payment of dividends to shareholders. Beyond that, the
4 markets have already offered strong and committed views about the viability of
5 this combination of the operations of FairPoint and Verizon Northern New
6 England.

7 **Allocation of Risks in the Transaction**

8 Q. Is Mr. Barber correct that the risks are very high and that your prefiled testimony
9 provides the "order and priority" of what FairPoint would do if operations became
10 distressed? (BARBER #2, p. 38).

11 A. Mr. Barber is not correct in his representation of my prefiled testimony. I
12 indicated in my direct testimony that FairPoint had options available to it, but
13 nowhere did I say that the company would "consider almost any alternative to
14 reduce costs before turning to its high dividend policy" (BARBER #2, p. 38). I
15 will affirm again that I do not expect FairPoint to be distressed nor do I expect the
16 company to engage in some plan to "siphon the rest of the cash" through
17 dividends to equityholders (BARBER #3, p. 16; BARBER #2, pp. 7, 24, 53).
18 FairPoint has made clear that its priorities are to meet its operating requirements,
19 make capital expenditures, and pay principal and interest on its debt; and the

1 company has been clear that its dividend policy will not be maintained if there is a
2 risk to the underlying business. Mr. Barber fundamentally misunderstands how a
3 prudent Board of Directors, like FairPoint's Board, establishes its dividend policy
4 and approves the payment of actual dividends quarterly based on financial results.
5 Just as importantly, FairPoint knows well that its stock price and its business
6 prospects will be adversely affected if it allows the operations to falter. Capital
7 expenditures and appropriate employee resources are fundamental to ensuring a
8 longer-term business. Additionally, as I included in my initial prefiled testimony,
9 there are credit agreement covenants that protect the business and consumers by
10 limiting the payment of dividends if necessary.

11 Q. Mr. Barber focuses on the risk that "synergies" (described by Mr. Leach in his
12 rebuttal testimony as "cost savings") might not be realized and that the operating
13 costs might rise faster than FairPoint has modeled (BARBER #3, pp. 16, 18),
14 precipitating lower free cash flow. Mr. Vickroy and Mr. Antonuk also raise the
15 same concerns, noting that the cost savings are "counter-intuitive" (VICKROY,
16 pp. 19-20; ANTONUK, p. 28). Is it realistic to assume that a smaller company
17 can manage to keep costs flat or even lower compared with the costs of a much
18 larger Bell Operating Company such as Verizon?

19 A. Yes. Private equity investors long ago realized that conglomerates could be
20 segregated into individual divisions, with the result that they could be operated

1 with more focus and efficiency. The ultimate outcome is improved valuations. In
2 the case of the FairPoint merger with Verizon's northern New England properties,
3 FairPoint's "synergies" are less the typical "scale and scope" benefits (challenged
4 in those terms by Mr. Antonuk and Mr. Vickroy) that I have observed when two
5 larger operations are merged and one overhead structure is eliminated. Here, it is
6 my understanding that the cost benefits in the $60 million to $75 million proposed
7 by FairPoint arise from the avoidance of certain costs allocated to the northern
8 New England operations. I believe that Mr. William King does an excellent job
9 of outlining some of the factors driving operating costs in the industry, whereby
10 smaller rural carriers can improve on margins and revenues at operations
11 previously owned by much larger carriers. Mr. King goes on to note that
12 historical BOC costs have had little bearing on the future cost trends in an
13 acquisition such as this one.

14 From my years of providing public equity analysis, I can offer the example of
15 Citizens Communications, which transformed itself through the acquisition of 1.1
16 million lines from Frontier and another 440,000 lines from GTE/Verizon between
17 mid-2000 and mid-2001. The company went from slightly under 1 million lines
18 in 1999 to over 2.4 million lines during that period, while the company assumed
19 $6 billion in debt in the course of the undertaking. The Citizens transaction has
20 been a success and provides an insight into how the financial markets view these

1 transactions. There are several similarities between the Citizens case and
2 FRP/NNE: (1) a smaller company was/is purchasing a larger set of telephone
3 assets; (2) debt was a major component of the financing (Citizens committed to an
4 even larger absolute and higher proportionate level of debt); (3) book equity was
5 relatively low and provided no reflection of valuation; and (4) the markets
6 were/are focused on free cash flow generation which resulted in higher revenues
7 and improving margins. To offer some perspective, I have provided selected
8 fundamental and financial data related to Citizens' operations in Table 6,
9 including quarterly and annual access lines, ILEC revenue per line, and ILEC
10 EBITDA margin. I highlighted in grey the quarters when the largest acquisitions
11 occurred (note the change in access lines to gain insight into other minor
12 acquisitions in 2000 and 2001). Key items in the table are, from the time of the
13 acquisitions, the improving quarterly ILEC EBITDA margins, driven by the
14 company's successful focus on costs and improving revenue per line per month.
15 Mr. King points to revenue per line per month and notes that Mr. Barber has
16 avoided mention of the opportunity to add more products. Mr. King is correct
17 that, aside from avoiding certain overhead allocations, the major way that carriers
18 have improved value is through rising revenues per line—without any rate
19 increases. I suggest that this pattern—improving revenues per line and improving
20 margins, contributing to stronger cash flows—is similar to what has unfolded in

1 virtually every ILEC acquisition that I followed during my years as an equity
2 analyst.

3 **Table 6: Citizens Communications quarterly and annual results 2000-2003**

4

	1Q	2Q	3Q	4Q	Full year
Year 2000					
Switched access lines (000)	1,021	1,017	1,224	1,371	**1,371**
Telco revenue/line/month ($)	73.68	74.51	68.05	64.49	
ILEC EBITDA margin	45.2%	43.6%	45.3%	46.4%	**45.2%**
Year 2001					
Switched access lines	1,387	1,404	1,418	2,481	**2,481**
Telco revenue/line/month	69.04	68.59	67.89	68.61	
ILEC EBITDA margin	51.9%	51.6%	46.8%	45.1%	**48.1%**
Year 2002					
Switched access lines	2,479	2,470	2,460	2,444	**2,444**
Telco revenue/line/month	68.32	69.46	70.43	70.97	
ILEC EBITDA margin	52.0%	53.3%	53.9%	53.5%	**53.2%**
Year 2003					
Switched access lines	2,435	2,419	2,404	2,386	**2,386**
Telco revenue/line/month	70.30	70.30	70.93	70.62	
ILEC EBITDA margin	54.4%	55.0%	54.7%	54.7%	**54.7%**

5 Source: Citizens Communications data; Balhoff & Rowe, LLC.

6 Q. What about the proposals posed by Mr. Antonuk and Mr. Vickroy that the
7 "synergies" should be excluded from the financial model? (See ANTONUK, pp.
8 18, 27-31; VICKROY, pp. 31, 38).

9 A. As I noted earlier, Mr. Antonuk has indicated that a primary concern is that it is
10 "atypical to find that a reduction in scope and scale will produce an increase in
11 cost efficiency" (ANTONUK, p. 28), and he notes that Liberty has "not seen any
12 substantial analytical support for [the proposed synergies]" (ANTONUK, p. 28).
13 I suggest that it is therefore an operational analytical exercise that FairPoint

1 should verify that "cost-savings" can actually be realistically modeled compared
2 with the costs reported on Verizon's NNE historical reports. If FairPoint can
3 support its realistic expectation that these savings will be realized, the
4 Commission might therefore re-instate the cost-savings into the model to verify
5 FairPoint's anticipated cash flows.

6 Q. Mr. Vickroy states that his analysis emphasizes the importance of the "system
7 conversion issue" which was troublesome in the Hawaiian Telcom ("HT")
8 divestiture, and he builds a "sensitivity analysis" that excludes large amounts of
9 cash flows to mirror the cash flow shortfalls in Hawaii (VICKROY, pp. 37, 30-
10 32). Please comment.

11 A. A key concern articulated in Mr. Vickroy's analysis is that the transition services
12 costs are "relatively unknown" and are "crucial to several areas with large
13 financial impacts (see VICKROY, p. 36). He develops an analysis that the
14 Transition Services Agreement ("TSA") might extend longer than expected with
15 the result that there could be higher-than-modeled costs and lower-than-modeled
16 cash flows, possibly similar to what occurred at HT (see confidential Exhibit I, p.
17 51). If this specific transition "risk" remains a major concern, I recommend that
18 the Commission should focus much more specifically on (1) the Commission's
19 confidence concerning whether the transition is proceeding smoothly and
20 verifiably (compared with the extraordinary failure in Hawaii that precipitated a

1 change in vendors from BearingPoint to Accenture) to determine whether the
2 costs are more likely to resemble FairPoint's model; (2) the specific costs that are
3 likely to occur if the process extends for a reasonable period of time (based on the
4 verified level of progress in FairPoint's transition) beyond FairPoint's estimate,
5 possibly two to four months; and (3) the competitive losses of lines that might
6 realistically be modeled if FairPoint were to delay the cutover from Verizon's
7 systems. I respectfully suggest that Mr. Vickroy's "sensitivity analysis" is likely
8 not informative for the Commission as he uses the EBITDA shortfalls from
9 Hawaiian Telcom in 2005 and 2006 to assume the same reductions in FairPoint's
10 EBITDA by $177 million and $219 million in 2008 and 2009, respectively, plus
11 the elimination of the synergies assumed by FairPoint. I believe that HT can and
12 should be distinguished from FairPoint in many ways, including the fact that HT
13 has a more commercial customer base (only 61% residential customer base which
14 means that it is more susceptible to competition), significantly more competitive
15 and commercialized activity because of the concentrated tourist industry
16 especially in large hotels, and has suffered from company-specific problems, such
17 as the first-quarter 2005 loss of UUNET as a customer (11,000)of HT's line losses
18 of 43,325 in 2005).[1] In short, the more appropriate FairPoint "sensitivity analysis"
19 with respect to the transition should extrapolate based on factors that more
20 accurately reflect FairPoint's transition progress to date, the assumption that

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[1] See Hawaiian Telcom, 2006 10-K, pp. 39, 41.

1 FairPoint will not have a costly change of software vendors, and few or no
2 extraordinary line losses associated with transition-related factors. If the
3 company's progress with Capgemini generates confidence, Mr. Vickroy's
4 sensitivity analysis based on HT's extraordinary transition costs and line losses
5 will prove even less applicable in this proceeding.

6 Q. How then do you expect FairPoint to manage its cash flows, operating costs and
7 margins?

8 A. As I noted in my prefiled testimony, FairPoint has several ways in which it can
9 manage its cash flows, including outperforming at the operating cost level or
10 generating additional revenues. My opinion is that FairPoint has room to improve
11 its margins through more efficient management of overhead and generation of
12 more revenues than the company has modeled. This approach is entirely
13 consistent with the data provided in the review of Citizens' acquisitions and with
14 the cases outlined in Mr. King's testimony. I expect that FairPoint will have
15 important revenue opportunities that are not captured in the model, as
16 telecommunications shifts from a voice-centric business to a data-centric
17 business. I note that the company believes that this is the case, which is one of
18 the reasons it has invested aggressively in data-ready access plant elsewhere, and
19 why the company—quite credibly—is stating repeatedly that it is committed to
20 expand its broadband reach in northern New England. I also believe that

1 changing technologies will provide FairPoint with greater opportunities to
2 manage operating costs, which include transport fees, switching expenditures, and
3 more efficient distribution/feeder loop plant.

4 **Clarification of Sensitivity Analysis**

5 Q. Is Mr. Barber correct that your sensitivity analysis "did not subject FairPoint's
6 projection of no growth in operating expenses to a reasonable sensitivity analysis"
7 (BARBER #3, pp. 4-6, 42).

8 A. No. My original table did not include testing growth greater than 1% annually
9 *above the company's projections*, which already included absolute growth
10 projections and even larger per-line growth. The reason was that I believe it is
11 unlikely that such a scenario will unfold, as I explain below.

12 Q. Mr. Barber represents that the model should reflect growth in total expenses
13 commensurate with a 5%-6% annual growth in unit operating costs, based on the
14 experience of Verizon and FairPoint over the 2002 to 2006 period (BARBER #3,
15 p. 6); is his analysis correct?

16 A. No. First, Mr. Barber's suggestion is that a minor 2% annual change in
17 assumptions about cash expenses would cause the company to fall well short of
18 its goals in terms of cash flow. It is important to note that those increases in the

1 total modeled cash expenses are assumed to rise cumulatively over the period.
2 Further, the per-line increase in cash expenses would, under Mr. Barber's
3 scenario, result in an 18% percent increase per line in cash expenses, by my
4 calculation, in the three-year period from 2009 to 2012 compared with the base in
5 FairPoint's model. The change in cash expenses would not be minor in the
6 scenario posed by Mr. Barber and would be contrary to Verizon's recent
7 experience of its direct expenses in the region. I believe that the cash costs would
8 almost certainly be managed by the company through reductions in variable cost-
9 items. Second, I disagree with Mr. Barber's assumption that unit costs will
10 continue to rise. In fact, Verizon's direct costs have been *declining* at an annual
11 rate of 1.8% from 2003 until 2006, and FairPoint will not incur Verizon's
12 allocated non-direct costs. In fact, Mr. Barber's own Schedule RB-6 in BARBER
13 #2 shows that total operating expense for Verizon for NNE in 2006 was $14
14 million less than it had been in 2003, and that expenses increased only nominally
15 ($4 million or 0.4%) from 2005 to 2006. Mr. Barber has included Verizon's
16 allocated overhead, which confuses his analysis of the direct cost trends. Third,
17 the sensitivity models (both mine and Mr. Barber's) analyzed potential changes in
18 total cash expenses. The models did not analyze unit costs. Total cash expenses
19 are very unlikely to increase nearly as fast as Mr. Barber posits. Mr. Barber's
20 commentary slips between total cost analyses and unit cost analyses. It is my
21 opinion that FairPoint's assumption of growth in total operating expenses before

1 depreciation and amortization appears conservative as the company projects
2 increases of 0.9% in 2010, 0.8% in 2011 and 0.6% in 2012. My original
3 sensitivity analysis which addressed a range of annual increases above the
4 company's assumptions of up to 1% is entirely appropriate. I note also that my
5 experience with acquirers, as Mr. King spells out in his testimony, leads me to
6 believe that operating cost improvements are possible or even likely.

7 Q. What data lead you to believe that FairPoint could improve the cost structure in
8 Northern New England?

9 A. I note that most independent carriers are generally able to run their operations far
10 more efficiently if we compare the other carriers' margins to those reflected in the
11 models proposed by FairPoint. I have included one of the tables that I created
12 during my analysis, which provides insight into the fact that FairPoint's projected
13 EBITDA margin is below industry averages. My view is FairPoint is
14 conservatively modeling an EBITDA margin in the high 30-percent range, while
15 the comparable companies are posting EBITDA margins in the high 40-percent to
16 low 50-percent range. Mr. King also provides similar information in his
17 testimony, affirming the upside for FairPoint if the company can begin to move
18 toward margins that reflect better focus on top-line revenues and better
19 management of allocated costs. My conviction is that the company is more likely

1 to outperform its model than underperform.

2 ***<u>**BEGIN CONFIDENTIAL INFORMATION**</u>***

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9 ***<u>**END CONFIDENTIAL INFORMATION**</u>***

10 In short, an outlook that assumes dramatic and uncontrolled growth in per-unit

11 expenses is not likely, and is in fact, foreign to Verizon's history of no growth in

1 direct expenses in NNE since 2002. I believe that an increasingly competitive
2 marketplace will reward dedicated carriers that are focused on investment and
3 customer demands.

4 **Market Perspectives**

5 Q. What do you mean that the capital markets expect outperformance by companies
6 rather than underperformance in a strategic acquisition? What does this mean for
7 this approval process?

8 A. It is my view that FairPoint designed its models to be reasonable or even
9 conservative. First, FairPoint management has a fiduciary responsibility to be
10 reasonable in evaluating its actions and in providing financial modeling in a
11 significant transaction like this one. In addition, companies are rewarded when
12 they eventually deliver better revenue opportunities, improved cost savings, and
13 higher-than-expected synergies. In this proceeding, I note that the Intervenor
14 testimony has focused almost solely on risks, some of which are near-term
15 transition issues, but the majority of which appear to be longer-term risks that can
16 be summarized as fears that cash flows will be lower than expected. In some
17 cases, the Intervenors' view is that FairPoint is too optimistic because it is
18 ignorant of the kinds of markets (wholesale or competitive), the design or alleged
19 flaws of the Verizon network, and the fundamental trends. By contrast with this

1 perspective, the financial analyst's bias is to assume that FairPoint, if it is a good
2 acquirer and a good financial investor, as it has been, will be conservative. To that
3 end, I note that FairPoint has fundamentally modeled the same kinds of services
4 and the same trends that Verizon has observed—with some improvements in
5 terms of long-distance penetration and some slower losses of access lines.
6 However, the company has not modeled any video revenues and no incremental
7 other data services. Further, FairPoint has a history that is consistent with this
8 more positive bias, as its acquisitions have *beat* the companies projections in
9 terms of modeled cash flows as represented in Mr. Leach's rebuttal testimony in
10 his graphic "Adjusted EBITDA from Acquired RLECs" which depicts the
11 outperformance in FairPoint projected and realized cash flows from 1998 to 2003.
12 My belief is that expenses and revenues are reasonably modeled, with
13 conservatism in terms of no expectations for incremental products or improved
14 margins.

15 Q. Are the intervenors correct in their testing of the assumptions?

16 A. All parties should test the various inputs and factors. Still, my observation is that
17 much of the intervenors' testimony assumes a "perfect storm" in which,
18 individually or severally, the risks result in an extreme outcome in terms of lower
19 cash flows that create a "distressed utility" which will fail the consumers.
20 Notably, that perfect storm assumes that FairPoint will exacerbate the cash flow

1 problem by continuing to pay the full $142 million annual dividend in the event of
2 underperformance, which I have already explained is not correct. My experience
3 as a financial analyst in the local exchange sector leads me to focus on factors that
4 no intervenor appears to be considering—that this transaction will result in a very
5 credible service provider for northern New England. I am convinced that the key
6 issues will prove out over time—that FairPoint will be a formidable competitor
7 focused on ILEC operations, on investment in the region, on productive
8 approaches to manage its costs, on a service platform that is superior, and on
9 satisfactory returns for its debt and equity investors. I believe that this
10 management team knows and understands telecommunications services, networks
11 and customers. The analysis that I have performed reveals a reasonable model,
12 relative conservatism about new services, a strong and experienced group of
13 telecommunications professionals, and sound financial backers.

14 Q. Are not the risks significant, especially as presented in the Form S-4A and
15 outlined by the Intervenors including Mr. Brevitz, who quotes the risks
16 extensively in his confidential testimony on pages 68-105 (see also BARBER #2,
17 p. 34)?

18 A. There are risks in competitive businesses, particularly those that are undergoing
19 the kinds of changes affecting ILECs. Investors and policymakers should
20 understand and be knowledgeable about all of these factors. However, I note that

1 the requirements regarding financial reporting in Forms S-4 or in financial
2 analysts' reports or in credit-rating-agencies' reports have become stricter over
3 the years. Financial regulators seek to avoid class actions lawsuits alleging failure
4 to disclose some risk and they therefore require that companies reporting to
5 investors (or analysts writing on stocks they cover) should provide detail on every
6 imaginable risk and avoid presentations of optimistic scenarios. No company or
7 investment firms wants to lose a lawsuit where shareholders claimed that they
8 were not apprised of some "risk." Accordingly, the risk sections in the offering
9 documents of most securities are quite extensive. It is important to note that risk
10 sections in financial documents are not included to handicap or quantify the
11 likelihood of any one or several events occurring, but are included to be all-
12 inclusive and to diminish the likelihood of litigation. On the other hand, I note
13 that the models and representations to investors in the proceedings before the
14 Commission nowhere include an "optimistic scenario" with respect to new
15 products, video services or margin expansion, in spite of the fact that those kinds
16 of outperformance in some form or another have unfolded in virtually every ILEC
17 acquisition I have studied.[11]

[11] I have studied the Verizon divestitures of local incumbent telephone operations in Texas, New Mexico, Oklahoma, Iowa, Missouri, Kentucky, Arkansas, Wisconsin, and Alabama. To the best of my knowledge, all those acquisitions not only were favorable, but resulted in outperformance by the acquirer.

1 Q. Mr. Vickroy notes his concern that, with high dividend companies, problems
2 regarding the dividend payment "can have devastating effects on [the] stock
3 price" (VICKROY, p. 12). Please comment.

4 A. Various Intervenors have indicated their concern about FairPoint's ongoing
5 access to the capital markets, and there appears to be a judgment that FairPoint
6 cannot alter its dividend payments in a scenario where cash from operations is
7 below expectations. My opinion is that there is a constellation of issues that
8 investors weigh with respect to high-dividend companies/stocks, including long-
9 term viability of the company, temporary operating shortfalls, competitive
10 positioning, the capital investment cycle, and opportunity for ongoing operating
11 improvements. Investors can be subtle in their assessment of a company's
12 operating and competitive positioning. At the most fundamental level, investors
13 will weigh the trends regarding cash flow generation—whether retained by the
14 company, reinvested in operations or paid out in dividends. I believe that
15 FairPoint has the flexibility to respond to operating cash shortfalls and investors
16 will be reasonable in assessing the constellation of issues that affect dividend
17 payments.

18 Q. Does the recent weakness in FairPoint's stock indicate that investors are less
19 confident in the company's long-term strategy?

1 A. No. The stock price closed the day before the announced merger at $18.54, then
2 spiked up 15.5% to close at $21.41 on January 16 when the companies disclosed
3 the agreement to merge operations. FairPoint's stock price stayed above the pre-
4 announcement price for four months—until May 8. The stock closed at $17.53
5 (5.4% lower than the pre-announcement price) on July 2, having dipped only as
6 low as $17.33 one day in 2007. I believe that the recent weakness in FRP is due
7 to market conditions as the other stocks in the sector have also weakened.

8 Q. What about the analysts' commentaries about execution risk (see BREVITZ, pp.
9 78-79) and the reports cited by Mr. Barber concerning the possibility that
10 FairPoint would not be able to pay its full dividend in 2007 without the
11 combination?

12 A. Analysts have an obligation clearly to state the facts, their analytical opinions and
13 the risks. Let me reiterate that analysts must list risks, which are present in all
14 investments, and are certainly present in this transaction. At the same time, I
15 know of no analyst that has expressed a negative view of financial outcomes
16 related to the combination of FairPoint with NNE, in spite of the transaction-
17 related risks. Even the analyst who expressed concern about whether FairPoint
18 would be able to pay its full dividend if the transaction were not consummated,
19 did not express a negative financial view if the transaction were to be completed.

1 I note that the financial community appears to see this combination as financially
2 attractive, even while being realistic about risks.

3 Q. What about Mr. Brevitz' concern that current debt markets are at historically
4 attractive levels and FairPoint may not today be able to finance or may not
5 eventually be able to roll over its debt at attractive levels (BREVITZ, pp. 9, 53-
6 54)?

7 A. Mr. Brevitz is correct that FairPoint cannot project where rates will be at the start
8 of 2008 or in 2011/2012 when the company will likely seek to roll over its debt.
9 With respect to the debt at the time of the transactions, it is my understanding that
10 FairPoint has a significant portion of the debt committed at specific spreads tied
11 to market rates. In addition, approximately 55% of the debt of the merged
12 company is already fixed via interest rate swaps that are in place today and will
13 continue following the proposed merger. Concerning the future, I note that
14 companies go out to the capital markets to seek attractive financing when
15 opportunities present themselves. My expectation is that FairPoint would attempt
16 to manage the timing of its refinancings. However, the point that Mr. Brevitz
17 raises is the possibility that FairPoint cannot manage its access to the credit
18 markets and then discovers that rates may rise, materially, although this again
19 ignores the future protection provided by the company's existing swaps. The
20 answer in such a case is that the company will do what it has been representing to

1 policymakers. If the "sky were to fall" and everything were to go wrong so that
2 cash flows were lower than expected and the obligations to debtholders were
3 higher than expected, such cash flow shortfalls would be borne by the
4 equityholders and not ratepayers.

5 Q. Does this conclude your testimony?

6 A. Yes. Thank you.