

**STATE OF NEW HAMPSHIRE  
PUBLIC UTILITIES COMMISSION**

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

**Additional Testimony  
of**

**RANDY BARBER**

**On Behalf of the  
Communications Workers of America and  
International Brotherhood of Electrical Workers**

**REDACTED (PUBLIC) VERSION**

February 4, 2008

1 **Q. Please state your name.**

2 A. Randy Barber

3 **Q. Are you the same Randy Barber who previously filed testimony on behalf of the Labor**  
4 **Intervenors in this proceeding?**

5 A. Yes.

6 **Q. What is the purpose of this additional testimony?**

7 A. My additional testimony is intended to assess the impact of the proposed New Hampshire  
8 settlement on FairPoint's financial fitness and prospects. I also incorporate my analysis of the  
9 Maine order and proposed Vermont settlement.

10 ***A. Impact of the Proposed New Hampshire, Vermont and Maine Settlements on***  
11 ***FairPoint's financial prospects.***  
12

13 **Q. Please describe your overall impression of modifications to this transaction as reflected**  
14 **in the proposed New Hampshire, Vermont and Maine settlements.**

15 A. They clearly represent an improvement over the originally proposed transaction, particularly  
16 with respect to requirements that will make it more likely that, in the future, FairPoint will  
17 behave more like a regional operating telephone company and less like an acquisitions-driven  
18 holding company.<sup>1</sup> I applaud the significant new provisions relating to service quality, rates,  
19 additional capital investments, dividend restrictions and other aspects of FairPoint's Northern  
20 New England operations. The fundamental question, however, is: *Do these changes improve*  
21 *FairPoint's financial condition enough for FairPoint to meet reasonable standards of*  
22 *financial fitness?* I believe that they do not.

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<sup>1</sup> The Maine PUC issued its Final Order on Friday, February 1, 2008 approving the transaction, but reserved the right to revisit its decision depending on the actions taken by regulators in New Hampshire and Vermont.

1           In the Maine and New Hampshire proceedings, Verizon agreed to provide FairPoint  
2           with a total “contribution” of \$297.5 million. This is comprised of \$235.5 million in cash that  
3           will be contributed to Spinco immediately prior to the transaction closes, \$12 million in  
4           repayment “forgiveness” for Verizon’s accelerated expenditures on DSL in Maine (both of  
5           these provisions were crafted during the Maine proceedings) and \$50 million in Verizon  
6           payments for FairPoint’s exclusive use in New Hampshire.<sup>2</sup> Verizon’s \$297.5 million is still  
7           woefully inadequate. As the Maine Hearing Examiner and OCA witness Brevitz have noted,  
8           in order for FairPoint to have solid prospects for financial viability, Verizon should have  
9           reduced the price by more than \$600 million. Moreover, as I demonstrate below, FairPoint  
10          has already been forced to make firm commitments that effectively use up about three-fourths  
11          of Verizon’s \$297.5 million, and it has agreed to contingent obligations that could far exceed  
12          it.

13           Equally as important, FairPoint’s financial model continues to rely upon the  
14          company’s unrealistically optimistic projections about its ability to reduce operating costs and  
15          then maintain them at an a-historically low level. Many of its key assumptions remain  
16          unchanged, including its projection for annual declines in the workforce of 4.0% to 4.5%.<sup>3</sup>  
17          This would result in a decline of 950 to 1,050 employees (27.1% to 30%) by 2015 (see table),  
18          while FairPoint projects declines in switched access lines of **{Begin Confidential [REDACTED] End**  
19          **Confidential}** and of access line equivalents of only **{Begin Confidential [REDACTED] End**

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<sup>2</sup> The \$50 million is comprised of two \$25 million contributions and is apparently intended for unanticipated contingencies with respect to FairPoint’s New Hampshire operations. The actual amount that Verizon contributes could be a slightly lower amount since the company has the right to make the second payment at closing, discounting the amount in recognition of its early payment.

<sup>3</sup> FairPoint says that it relied on a verbal representation by Verizon that the 4.0% to 4.5% net attrition number represented normal turnover and was not influenced by any special incentives for active employees to retire. However, I am informed that Verizon offered incentives for employees to leave the company on at least six occasions during 2004, 2005 and 2006. I am further informed that these offers were dated October 5, 2004, December 2, 2004, March 24, 2005, November 4, 2005, April 31, 2006 and November 13, 2006. Based on this information, it would appear that Verizon misled FairPoint with respect to the “normal” net turnover rate that it experienced over the past three years.

1       **Confidential}**. When more realistic assumptions are used, FairPoint fails reasonable tests of  
 2       financial fitness, as I discuss below.

**Projected Net Declines in FairPoint's Workforce: 2008-2015**

Annual % Net Decline	Workforce At Close*	At Year-End							
		2008*	2009	2010	2011	2012	2013	2014	2015
4.00%	3,500	3,395	3,259	3,129	3,004	2,884	2,768	2,657	2,551
	<i>Net Decline</i>	<i>(105)</i>	<i>(241)</i>	<i>(371)</i>	<i>(496)</i>	<i>(616)</i>	<i>(732)</i>	<i>(843)</i>	<i>(949)</i>
4.50%	3,500	3,382	3,230	3,084	2,946	2,813	2,686	2,566	2,450
	<i>Net Decline</i>	<i>(118)</i>	<i>(270)</i>	<i>(416)</i>	<i>(554)</i>	<i>(687)</i>	<i>(814)</i>	<i>(934)</i>	<i>(1,050)</i>

3                               \* Assumes March 31, 2008 close (implying 2008 net employment losses are 75% of a full year)

4                               The proposed Vermont stipulation requires FairPoint to spend tens of millions of  
 5       additional dollars beyond the provisions of the Maine settlement without any additional  
 6       funding from Verizon. It forces FairPoint to place tens of millions of additional dollars at risk  
 7       if it fails to almost immediately fix the many service quality problems it will inherit from  
 8       Verizon (caused by Verizon's chronic underinvestment in that state).

9                               Further, under the terms of the Maine stipulation, if FairPoint misses its financial  
 10       projections by a fairly small margin in 2011, it could be required to find an extra \$150 million  
 11       somewhere to pay down additional debt. Alternatively, FairPoint could choose to reduce debt  
 12       or expenses in 2011 or cut dividends in 2013 until it refinances its debt. FairPoint also could  
 13       avoid this provision entirely by refinancing its debt during 2012.

14                              Moreover, this transaction could create profound – even perverse -- incentives for  
 15       FairPoint to cut expenses and capital spending in 2011 in a desperate effort to avoid this  
 16       requirement (which was inserted at the very last minute in the Maine PUC hearings), just  
 17       when it should be continuing to invest heavily in rebuilding the communications network it  
 18       will have inherited from Verizon.

1 **Q. Please describe your analysis of these changes, based on non-confidential information, as**  
2 **represented by Attachment 1P, which appears on page 24 of this testimony.**

3 A. Attachment 1P provides something of a “balance sheet” detailing the new hard commitments  
4 and contingent obligations that FairPoint has assumed, as well as the elements of Verizon’s  
5 “contributions” to FairPoint, as a result of proposed or approved settlements in Maine, New  
6 Hampshire and Vermont. In effect, it provides a report on how Verizon’s \$300 million in  
7 new commitments (or price reductions) will be spent. This part of my analysis is derived  
8 from non-confidential data, and describes the basic elements of the proposed modifications to  
9 the transaction. I relied on information contained in FairPoint and Verizon submissions to the  
10 Maine, New Hampshire, and Vermont regulators, plus data filed with the Securities and  
11 Exchange Commission. Subsequently, I will discuss the results of various analyses that I  
12 have performed based on confidential data.

13 The bottom line is that the Maine, New Hampshire, and Vermont stipulations in a  
14 number of important respects only exacerbate FairPoint's already unacceptably risky  
15 prospects. Moreover, they create the potential for some quite perverse incentives to  
16 FairPoint’s behavior.

17 While Verizon will "contribute" \$297.5 million to the deal, FairPoint has already used  
18 up about three-fourths of this money: an estimated \$238.7 million in hard expense  
19 commitments and newly disclosed increased costs (initial broadband spending and a 2 month  
20 TSA extension).<sup>4</sup>

21 In addition, FairPoint has agreed to almost \$200 million in increased contingent  
22 expenses. This new exposure includes the last-minute \$150 million promise made in the  
23 Maine proceedings, up to \$37.5 million in increased capital spending in Vermont should

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<sup>4</sup> These computations are in nominal, pre-tax dollars.

1 FairPoint fail to meet specific service quality metrics, and up to \$9 million in fines should it  
2 fail to meet the new proposed standard of 100% DSL availability in 50% of its exchanges.

3 In sum, FairPoint has committed to some \$435.2 million in new firm or contingent  
4 expenses, while Verizon has agreed to contribute \$297.5 million<sup>5</sup> to Spinco or FairPoint (with  
5 certain restrictions or requirements), thus effectively reducing the purchase price that  
6 FairPoint will be required to fund.

7 As noted below, FairPoint also has agreed to reduce its dividend by 35%, and to apply  
8 nearly all of the savings to debt reduction. The reduced-dividend commitment lasts until  
9 FairPoint is able to achieve a leverage ratio below 3.50x for three consecutive quarters, at  
10 which point it would be permitted to increase its dividend. Under FairPoint's Revised Base  
11 Case scenario, the dividend restriction would end in 2011. For the purposes of its  
12 submissions to the Commission, however, FairPoint has projected the reduced dividend level  
13 for the entire 2008 – 2015 period. Since the dividend reduction is approximately \$50 million  
14 per year, FairPoint suggests that it will reduce dividends by \$400 million, applying all of this  
15 amount to debt reduction. While FairPoint might indeed maintain a reduced dividend rate  
16 throughout the projection period, it would have the right to reinstate its dividends under the  
17 Revised Base Case scenario. If FairPoint chose to reinstate its full dividend, FairPoint's total  
18 dividend reduction (and its application to debt repayment) would total approximately \$200  
19 million through 2015.  
20

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<sup>5</sup> The \$50 million that Verizon committed as part of the proposed New Hampshire stipulation is apparently restricted to funding for unanticipated eventualities, as proposed by FairPoint and approved by the Commission. By its very nature, this provision cannot be modeled, since the uses to which it will be put is as yet unknown. However, Verizon did agree to provide FairPoint with an additional \$50 million in cash and, at some point, FairPoint can certainly be expected to expend these funds. Thus, they are reflected on both sides of the Attachment 1P "balance sheet."

1 ***B. The Proposed New Hampshire Stipulation fails to meet reasonable standards of***  
2 ***financial fitness***

3

4 **Q. Earlier, you stated that the proposed changes to the transaction do not improve**  
5 **FairPoint's financial condition enough for it to meet reasonable standards of financial**  
6 **fitness. Please elaborate.**

7 A. Consider these four measures of financial fitness:

8 (1) The ability of the business to pay dividends to stockholders that are sustainable and  
9 reasonably reflective of the value stockholders have invested in the business.

10 (2) The ability of the business to meet its obligations to lenders and employees.

11 (3) The ability of the business to invest in new capital plant and equipment.

12 (4) The company's ability to perform under a reasonable set of adverse conditions.

13 Even accepting all of FairPoint's assumptions, the proposed settlements do not enable  
14 FairPoint to meet any of the first three tests. If one evaluates a reasonable set of less  
15 optimistic assumptions than FairPoint used, there is no question that the proposed stipulation  
16 does not enable FairPoint to meet the minimum standards of financial fitness.

17 ***First***, the new company should be able to pay a dividend to common stockholders that  
18 is reasonable. This past summer the Montana Public Service Commission rejected a proposed  
19 acquisition of an energy utility, NorthWestern Corp., based on this standard. That  
20 commission found that "U.S. utilities typically pay out 60 to 70 percent of net earnings in  
21 dividends" but the proposed acquirer would pay out in excess of 100 percent of net earnings.  
22 Verizon currently pays dividends equal to about 75% of its net income, which is in line with  
23 the utility industry average.

1           The Montana commission then explained why it would be so problematic for a public  
2 utility to consistently pay dividends in excess of net income: “In normal utility operations,  
3 retained earnings provide a vital source of financial strength for capital investment and as  
4 reserves that are available during unexpected financial strains. Regularly paying out dividends  
5 in excess of net earnings by a utility is inappropriate and risky because having insufficient  
6 reserves on hand could adversely affect the utility's ability to provide adequate service.” I  
7 concur with the Montana commission’s statements in this regard.

8           Based on this and other financial factors – including the high amount of debt the  
9 acquirer would take on – the Montana commission rejected the proposed transaction.

10           Under the proposed stipulation – and accepting all of FairPoint’s projections –  
11 FairPoint would pay dividends of \$92 million per year from 2009 through 2011, and would  
12 have the right to then increase the dividend back to the \$142 million that it originally  
13 projected beginning in 2012. Although FairPoint’s submission does not reflect the  
14 reinstatement of the \$142 million in dividends which is permitted under the proposed  
15 stipulation, if it were to do so FairPoint would pay out **{Begin Confidential [REDACTED] End**  
16 **Confidential}** in dividends, but would earn just **{Begin Confidential [REDACTED] End**  
17 **Confidential}** over this eight-year period (see further discussion on this below). Even if it  
18 decides not to reinstate its dividends to the \$142 million level, FairPoint will still be paying  
19 **{Begin Confidential [REDACTED] End Confidential}** in dividends on profits of **{Begin**  
20 **Confidential [REDACTED] End Confidential}**.

21           This is not sustainable and does not represent a reasonable dividend policy for a public  
22 utility. As the Montana commission stated, continually paying out dividends in excess of net



1 income is unreasonable. That describes FairPoint’s financial projections – even after  
2 considering the stipulation.

3 *Second*, the stipulation will not enable FairPoint to simultaneously meet its obligations  
4 to its lenders and employees. FairPoint’s expense projections are extremely optimistic  
5 because they assume the downsizing of the workforce by 4 to 4.5 percent each year.

6 The Maine Hearing Examiner found FairPoint’s expense projections to be  
7 “unrealistic,” “aggressive and overly optimistic.” The Vermont Public Service Board agreed  
8 and found that FairPoint’s employee attrition assumption was “implausible.” The Board  
9 concluded that FairPoint’s expense projections were “optimistic, and under reasonably  
10 foreseeable circumstances might force FairPoint to decide whether to reduce dividends or  
11 reduce capital or operating expenses.”

12 The proposed stipulations do not address this concern. Of course, with a more  
13 realistic projection of operating expenses, FairPoint’s net income will be even lower.

14 Moreover, FairPoint also will not be reasonably able to meet its commitments to  
15 employees. At closing, FairPoint will assume Verizon’s obligation to provide most of  
16 Verizon’s current employees with certain retirement benefits, including health care and life  
17 insurance. According to FairPoint’s Discovery Model, the company projects that at closing it  
18 will have **unfunded liabilities of {Begin Confidential [REDACTED] End Confidential}**  
19 (referred to as Pension and OPEB Liabilities). Most of this amount is for non-pension  
20 retirement benefits. These liabilities will grow each year, so that by 2015 they will total  
21 **{Begin Confidential [REDACTED] End Confidential}**.

1           According to Verizon's annual report for 2006 at the corporate level, Verizon had \$4.3  
2 billion set aside to help meet its non-pension retirement obligations.<sup>6</sup> That represented about  
3 16% of its total obligation for retiree health care and life insurance. None of that \$4.3 billion  
4 trust fund is being transferred to FairPoint. If it were, because FairPoint would be getting 1%  
5 to 1.5% of Verizon's workforce,<sup>7</sup> it might be allocated \$40 to \$60 million from this trust fund.

6           Further, Verizon contributed more than \$1 billion in 2006 to help fund these  
7 obligations. FairPoint's projections do not include any payment comparable to the \$1 billion  
8 per year Verizon is contributing to its trust fund. FairPoint would be getting about 1% to  
9 1.5% of Verizon's workforce and FairPoint should be spending at least \$10 to \$15 million per  
10 year to fund these costs. In fact, FairPoint is not even setting up a trust fund to help meet its  
11 non-pension retirement obligations to its employees.

12           Instead, FairPoint just assumes that the liability will continue to grow by \$30 million  
13 per year or more - and it won't have to set aside a penny to provide these benefits to retirees.

14           The proposed settlements do nothing to change this. By 2015, FairPoint will have an  
15 unfunded liability of almost **{Begin Confidential ██████████ End Confidential}** dollars  
16 and it will have no ability to make those payments, because it could easily have \$2 billion or  
17 more of long-term debt that has to be paid off.

18           Even with the proposed stipulations, FairPoint simply does not have the ability to meet  
19 its obligations to its employees and retirees. There isn't an "extra" \$200 million or more to  
20 set up a trust fund to help FairPoint meet its obligation to Verizon employees. There isn't an  
21 "extra" \$30 million per year to fund this liability going forward because FairPoint is paying  
22 out nearly all of its available cash in stock dividends.

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<sup>6</sup> Note 15; filed with the Securities and Exchange Commission in March 2007

<sup>7</sup> Year-end 2006 Verizon had 242,000 employees (Verizon 2006 10-K)

1           Simply, FairPoint will be unable to keep its promises to current Verizon employees,  
2 unless it breaks its promises to FairPoint's lenders and stockholders. It cannot meet its  
3 obligations to all three.

4           **Third**, FairPoint will not be able to make reasonable levels of investment in new  
5 capital facilities and equipment. FairPoint is projecting a level of capital investment that is  
6 substantially less than Verizon's historic level of investment. Even with the increased capital  
7 spending in the proposed stipulations, FairPoint's commitment to Northern New England will  
8 be substantially less than Verizon's has been for the past six years. This is particularly  
9 apparent in New Hampshire where Verizon has invested more than **{Begin Confidential** █████  
10 █████ **End Confidential}** per year in recent years. In contrast, the proposed settlement  
11 requires FairPoint to invest only about \$50 million per year in capital expenditures in New  
12 Hampshire.

13           **Fourth**, FairPoint will not be able to respond to a reasonable set of adverse conditions.  
14 I used the same conditions that FairPoint's Board of Directors asked its management to  
15 evaluate in January 2007 before agreeing to the deal.

16           The critical assumption in that sensitivity analysis is that, through some combination  
17 of revenue decreases and expense increases, FairPoint's EBITDA would be \$67 million per  
18 year lower than projected. This \$67 million assumption is roughly equivalent to taking away  
19 FairPoint's unrealistic employee attrition assumption, and leaving everything else the same.  
20 Or you could view it as assuming FairPoint will not get the \$60 to \$75 million in synergy  
21 savings it projects from allegedly being more efficient than Verizon.

22           As described below, one iteration of FairPoint's Discovery Model contained a  
23 sensitivity analysis that assumed a **{Begin Confidential** █████ █████ **End Confidential}**

1 reduction in EBITDA. I ran these assumptions through FairPoint's financial model, including  
2 the effects of the stipulations and found that FairPoint's dividends would be **{Begin**  
3 **Confidential [REDACTED] [REDACTED] End Confidential}** greater than FairPoint's net income (which  
4 would be negative), that FairPoint would have almost as much debt in 2015 as it would have  
5 at closing, that FairPoint's shareholders' equity would be wiped out, and that FairPoint would  
6 have no prospects of even approaching an investment-grade bond rating. Indeed, under that  
7 case, it would be difficult to see how FairPoint could refinance its debt on reasonable terms  
8 when it comes due.

9 In summary, FairPoint will be unable to pay its lenders, pay its promised dividends to  
10 stockholders, invest in the facilities Northern New England needs, and meet its obligations to  
11 its employees. Projections of FairPoint's finances using all of FairPoint's assumptions, even  
12 after considering the effects of the proposed stipulations, show that FairPoint lacks the  
13 capability to meet even three of those commitments, let alone all four. If we add in a less  
14 optimistic set of assumptions, there is no doubt that FairPoint would be in dire financial  
15 straits.

16 The Maine Hearing Examiner and OCA witness Brevitz were right – it would take on  
17 the order of \$600 to \$700 million to cure this deal and make FairPoint financially viable. The  
18 proposed stipulation provides less than half that amount and does not enable FairPoint to  
19 achieve the minimum levels of financial fitness.

1 ***C. FairPoint's most recent version of its confidential Discovery Model***

2

3 **Q. You said that you have analyzed FairPoint's most recent version of its confidential**  
4 **financial model, which reflects the provisions of the proposed settlements in Maine, New**  
5 **Hampshire, and Vermont. Please describe your analysis.**

6 A. At this point, I am quite familiar with FairPoint's model, and I have evaluated multiple  
7 iterations of it during the course of the regulatory proceedings in the Northern New England  
8 states. I received the latest version of the model on January 25.

9 I performed an analysis of certain key metrics such as net income, dividends, free cash  
10 flow, unfunded pension and OPEB liabilities, shareholder equity, goodwill and so forth.  
11 Some of these analyses are incorporated in tables that I present in this testimony. I also  
12 performed certain analyses to identify which elements of the original model were affected (or  
13 not) by the changes made by FairPoint.

14 I then generated outputs that captured the results of the scenarios that were contained  
15 in the revised model. These outputs are provided with my testimony as Labor Exhibit A1  
16 (confidential). I have also incorporated certain of the summary results of these scenarios in  
17 tables that I present in this testimony. The scenarios that I tested include:

- 18 • The baseline "Revised Base Case" with dividends reduced by 35% (to \$92  
19 million) for the entire 2008-2015 projection period;
- 20 • The "Revised Base Case" with dividends restored to 100% (\$142 million) in 2012,  
21 as permitted in the proposed stipulation;
- 22 • The Vermont PSB's "Steady State" scenario which modifies certain revenue  
23 assumptions based on line losses at a steady 6 percent through the entire projection  
24 period (which is above FairPoint's base case projections);

- 1 • The PSB's "VoIP" scenario which assumes the Steady State scenario's 6 percent  
2 annual line loss, but adds another 5 percent line loss in 2009 and 2010 "due to the  
3 arrival of cable-based VoIP service;" and
- 4 • What I refer to as the MAC/NoSynergies scenario that increases expenses **{Begin**  
5 **Confidential [REDACTED] End Confidential}** per year. This approximates the  
6 worst case "Material Adverse Change" test that FairPoint's board requested prior  
7 to agreeing to this transaction. It also approximates a scenario under which  
8 FairPoint achieves none of the projected synergies from the transaction. It also  
9 could be viewed as approximating the impact of removing FairPoint's unrealistic  
10 employee attrition assumption, combined with a more modest reduction in base  
11 case revenues.

12 For the most part, my changes to the model left the underlying formulas and data  
13 undisturbed. However, I did alter one set of formulas to permit an automatic determination of  
14 dividend rates as required or permitted under the stipulations. In addition, I created a table on  
15 the key summary results worksheet ("Output to NH and VT") that permits turning the  
16 "switches" (0 or 1, no or yes) on or off for the various scenarios. On FairPoint's original  
17 version of the model, these switches need to be manually invoked on several different  
18 worksheets. Besides including an on/off switch for the dividend calculation, I changed the  
19 switches on these various worksheets into look-up functions, reflecting the settings on the  
20 summary results worksheet. On certain other worksheets, changes were made, to accumulate  
21 totals or test results, but other than the changes described above, no other changes were made  
22 to the functioning of this model. All other calculations that were added stand alone and in no  
23 way impact the operation of pre-existing formulas and functions. A more complete

1 description of the changes I made is contained on the “LaborIntervenorNote” worksheet in the  
2 adjusted version of the confidential Discovery Model for New Hampshire that I have provided  
3 to FairPoint, Verizon, Staff, and OCA.

4 In the scenarios that I evaluated, I did not project how FairPoint would respond if its  
5 Leverage Ratio reached 3.6 or higher at year-end 2011, thus requiring (under the Maine  
6 settlement) FairPoint to pay down debt by an additional \$150 million in 2012 or eliminate  
7 dividends entirely in 2013 until its bank debt is refinanced. There are two reasons for this:  
8 First, some scenarios produce Leverage Ratios that could be brought below 3.6 with a fairly  
9 small additional reduction in debt (or increase in EBITDA) in 2011. It seems likely that,  
10 confronted with such a situation, FairPoint would take action in 2011 to avoid triggering the  
11 much more financially challenging alternatives. Second, while two scenarios result in such  
12 high 2011 Leverage Ratios that it is fairly inconceivable that FairPoint would have the  
13 resources to cure them preemptively, it is also not possible to project what actions FairPoint  
14 would take after this provision is triggered (cut dividends and sell assets in 2012 to pay down  
15 \$150 million in debt, cut dividends in 2013, or refinance its debt earlier than planned). I have  
16 computed the amounts required under each scenario to bring FairPoint’s 2011 Leverage Ratio  
17 to 3.6, as I discuss below.

18 ***D. Selected Results of Scenario Runs.***  
19

20 **Q. Please present and discuss the summary results from the scenarios that you ran that you**  
21 **believe are most analytically useful.**

22 **A.** As I discuss elsewhere, a conscious policy of paying dividends in excess of net income is not  
23 sustainable and does not represent a reasonable dividend policy for a public utility. Even in

1 FairPoint’s “Revised Base Case” scenario (which in its original form projects that FairPoint  
 2 will not restore dividends to the 100%, or \$142 million, level in 2012 as the proposed  
 3 stipulation would permit), dividends are 182% of projected net income, as I show in the  
 4 following table.

**Dividends Versus Net Income: 2008 - 2015**  
*Projected Totals for the Period*

	Net Income (\$million)	Dividends (\$million)	Dividends In Excess of Net Income	Dividends as % of Net Income
Case 2 - "Revised Base Case" (Constant Dividend @ \$92m)	█	█	█	182%
Case 2 - "Revised Base Case" (Dividends restored to 100% in '12)	█	█	█	243%
Case 3 - "Steady State"	█	█	█	465%
Case 4 - "VoIP"	█	█	█	nm
Case A - MAC/NoSynergies	█	█	█	nm

5 *nm = not meaningful when Net Income number is negative*

6 If dividends are fully restored in 2012, they are 243% of projected net income. The  
 7 “Steady State Scenario,” which results in a significant decrease in net income still results in  
 8 the same dividend payout as under the version of the “Revised Base Case” that FairPoint  
 9 modeled, projecting dividends that are four times net income over the 2008 – 2015 period.  
 10 Similarly, the Mac/NoSynergies scenario permits a constant \$92 million per year dividend  
 11 payout, even though it results in a net loss for the period. The “VoIP Scenario” results in the  
 12 elimination of dividends in 2012.



## Dividends and Free Cash Flow

*2008-2015 Period*

	FCF vs Dividends			
	Dividends (\$million)	Free Cash Flow	Free Cash Flow In Excess of Dividends	Free Cash Flow As % Dividends
Case 2 - "Revised Base Case" (Constant Dividend @ \$92m)	████	██████	████	178%
Case 2 - "Revised Base Case" (Dividends restored to 100% in '12)	████	██████	████	138%
Case 3 - "Steady State"	████	██████	████	144%
Case 4 - "VoIP"	████	██████	████	153%
Case A - MAC/NoSynergies	████	██████	███	99%

1  
 2           One of the scenarios results in dividend payouts exceeding free cash flow, a result that  
 3           could only be enabled by obtaining external funds. Comparing the Revised Base Case with  
 4           and without dividend reinstatement demonstrates that the impact on free cash flow of  
 5           increasing FairPoint’s dividends to their previously high levels is more than {Begin  
 6           **Confidential** █████ █████ **End Confidential**} over the period modeled. The “VoIP  
 7           Scenario” produces a relatively high free cash flow to dividend level precisely because the  
 8           proposed stipulation would require FairPoint to eliminate dividends entirely in 2012. The  
 9           MAC/NoSynergies scenario produces a slightly negative margin between dividends and free  
 10          cash flow, in large measure because FairPoint would be permitted to maintain its \$92 million  
 11          dividend even in the face of an assumed unfavorable annual change of {Begin Confidential  
 12          ████ █████ **End Confidential**} in revenue, operating expenses or a combination of both.<sup>8</sup>

<sup>8</sup> As noted above, these scenarios do not attempt to evaluate the impact of failure to achieve a Leverage Ratio below 3.6 in 2011, but as can be seen in the table, FairPoint would almost certainly be forced to eliminate dividends (either in 2012 or 2013 and possibly thereafter) as part of its compliance with the Maine stipulation, unless it refinances its debt before 2013.

**Changes in Shareholder Equity: Year-End 2007 - Year-End 2015**

	Year-End 2007	Year-End 2015	\$ Change	% Change
Case 2 - "Revised Base Case" (Constant Dividend @ \$92m)	█	█	█	-61.4%
Case 2 - "Revised Base Case" (Dividends restored to 100% in '12)	█	█	█	nm
Case 3 - "Steady State"	█	█	█	nm
Case 4 - "VoIP"	█	█	█	nm
Case A - MAC/NoSynergies	█	█	█	nm

*nm = not meaningful when Shareholder Equity number is negative*  
 FairPoint's Discovery Model assumes that the transaction closes at year-end 2007.

1  
 2           Even though FairPoint projects under its Revised Base Case that shareholder equity is  
 3 positive for every year of the projection period, it still declines by almost two-thirds from  
 4 year-end 2007 through year-end 2015. Moreover, under FairPoint's own preferred  
 5 assumptions (Revised Base Case), shareholder equity would be wiped out if the company  
 6 reinstated dividends to the full \$142 million in 2012, as it would have a right to do under the  
 7 proposed stipulations. In fact, shareholder equity "goes negative" under all but FairPoint's  
 8 basic scenario, which contains the company's same over-optimistic assumptions that have  
 9 been so roundly criticized. Interestingly, the "VoIP Scenario," which yields by far the worst  
 10 net income results, actually produces the smallest level of negative shareholder equity because  
 11 dividends are eliminated in 2012.

12

## Projected 2011 Leverage Ratios and Additional Debt Reduction Required to Reach 3.6

	Net Debt	Covenant EBITDA	Leverage Ratio	Debt Req'd for 3.6 Leverage Ratio in 2011	Add'l debt reduction needed to reach 3.6*
Case 2 - "Revised Base Case" (Constant Dividend @ \$92m)	██████	██████	██████	██████	(\$91)
Case 2 - "Revised Base Case" (Dividends restored to 100% in '12)	██████	██████	██████	██████	(\$91)
Case 3 - "Steady State"	██████	██████	██████	██████	\$33
Case 4 - "VoIP"	██████	██████	██████	██████	\$507
Case A - MAC/NoSynergies	██████	██████	██████	██████	\$447

\*Negative number implies no additional debt reduction required

As noted above, I did not attempt to include projections for what pre-emptive or remedial actions FairPoint might take if it appears likely to fail the 3.6 Leverage Ratio test for 2011. The table above reports the difference between FairPoint's projected year-end 2011 net debt, and the amount of debt that would be required to be reduced in 2011 in order to achieve the 3.6 level (a negative number indicates that the Leverage Ratio is already below 3.6).<sup>9</sup> As can be readily determined, the Steady State scenario would require relatively small additional debt reduction to avoid triggering this provision of the Maine order, while the VoIP and MAC/No Synergies scenarios would require around a {Begin Confidential ██████████ End Confidential} dollars in pre-emptive payments.

### Changes in Unfunded Pension and OPEB Liabilities, 2008-2015

	2008	2009	2010	2011	2012	2013	2014	2015
Unfunded P&OPEB as % New Bonds	41%	47%	52%	58%	64%	70%	76%	83%
Unfunded P&OPEB as % Total Long Term Liabilities	8%	10%	11%	13%	14%	16%	18%	20%
Unfunded P&OPEB as % Net Debt (Revised Base Case, Dividends remain at \$92 million)	10%	12%	14%	17%	20%	24%	28%	33%
Total Unfunded Pension and OPEB Liabilities	██████	██████	██████	██████	██████	██████	██████	██████

<sup>9</sup> Increasing EBITDA would be another way to lower the Leverage Ratio.

## Total Unfunded Pension and OPEB Liabilities as a % of Net Debt

*Year-End 2007 - Year-End 2015*

	Year-End 2007	Year-End 2015
Case 2 - "Revised Base Case" (Constant Dividend @ \$92m)	9.2%	32.8%
Case 2 - "Revised Base Case" (Dividends restored to 100% in '12)	9.2%	28.4%
Case 3 - "Steady State"	9.2%	27.8%
Case 4 - "VoIP"	9.2%	25.9%
Case A - MAC/NoSynergies	9.2%	23.2%

FairPoint's Discovery Model assumes that the transaction closes at  
year-end 2007.

1  
2 As the Labor Intervenors have repeatedly stressed, we are extremely concerned with  
3 FairPoint's plan to accumulate \$257 million in new unfunded Pension and OPEB liabilities  
4 over the 2008 – 2015 period, for a total of **{Begin Confidential ██████████ End**  
5 **Confidential}** by year-end 2015. As can be seen in the two tables above, unfunded Pension  
6 and OPEB obligations are projected to rise dramatically in relation to other FairPoint  
7 obligations. Also, unfunded Pension and OPEB obligations are projected to rise from a level  
8 at year-end 2008 representing 41% of the value of the new bonds that FairPoint will issue in  
9 connection with this transaction to 83% of these bonds' value at year-end 2015. This is not  
10 because FairPoint plans to pay off some of these bonds. It does not. Rather, it effectively  
11 intends to "borrow" additional amounts each year from its Pension and OPEB accounts.

12 These represent completely unfunded obligations to FairPoint employees when they  
13 retire. Labor Intervenors' concern is that the company may not be in a position to honor these  
14 obligations. As I previously testified, companies that find themselves under financial pressure  
15 have reduced or eliminated these benefits, particularly for retiree health care. Should  
16 FairPoint's overly optimistic projections not be realized, the concern is that such a course of



1 **Q. In light of your concern with FairPoint’s projected level of unfunded retirement**  
 2 **obligations, have you analyzed FairPoint’s projected level of total long-term liabilities**  
 3 **under various scenarios?**

4 A. Yes, I have. I compared FairPoint’s total long-term liabilities, which are primarily comprised  
 5 of long-term debt, deferred taxes, and funded retiree benefits, at closing (year-end 2007 in the  
 6 model) and at year-end 2015. The following table summarizes these results:

## Changes in Total Long-Term Liabilities At Closing (Year-end 2007) Compared to Year-end 2015

Long-Term Liabilities	Year-end 2007	Year-end 2015				
		Base Case	Base Case w/Div. Rein.	Steady State	VoIP	MAC/NoSyn
Net Debt	█	█	█	█	█	█
Unfunded OPEB	█	█	█	█	█	█
Other	█	█	█	█	█	█
Deferred Taxes	█	█	█	█	█	█
7 Total	█	█	█	█	█	█

8 The table shows that, even under FairPoint’s base case, it is showing only a very modest (less  
 9 than 15%) reduction in total liabilities by year-end 2015. In the other scenarios I examined,  
 10 the decrease in total liabilities is only about 5% or less during this period, with the MAC/No  
 11 Synergies case actually showing a 5% *increase* in total liabilities compared to the amount at  
 12 closing. In other words, while FairPoint is projecting some fairly significant reductions in net  
 13 debt, under certain scenarios, those reductions are being largely offset by unfunded increases  
 14 in retirement obligations and (in some cases) deferred taxes. Indeed, in the MAC/No  
 15 Synergies scenario, increases in unfunded retirement obligations more than offset the modest  
 16 reductions in debt and deferred taxes, resulting in an overall increase in total long-term  
 17 liabilities.

1 I conclude that the rosy picture that FairPoint tries to paint is simply not accurate.  
2 Even under the best conditions, FairPoint will be paying down its obligations to investment  
3 banks while building up massive unfunded obligations to its employees. The net effect will  
4 be very little change in FairPoint's total obligations. Under less favorable conditions,  
5 FairPoint will end up owing more in 2015 than it will owe at closing – largely because of its  
6 failure to fund its promises to its employees and retirees. But, of course, FairPoint will  
7 continue to pay dividends to its investors that greatly exceed its earnings. FairPoint's  
8 approach is clear – make exorbitant payments to stockholders, satisfy the investment banks,  
9 and make promises it can't keep to its employees. In my opinion, this is further evidence that  
10 FairPoint will fail to meet reasonable standards of financial fitness.

11 ***E. Conclusions Regarding the Impact of the Proposed New Hampshire Stipulation***  
12

13 **Q. Please summarize any additional comments you may have and the conclusions you have**  
14 **reached.**

15 A. FairPoint's analyses do not fully and accurately reflect the terms of the proposed stipulations.  
16 For example, FairPoint does not evaluate the potential impact of the 3.6 Leverage Ratio/\$150  
17 million provision and it does not reflect FairPoint increasing its dividends when it would be  
18 permitted to do so.

19 FairPoint continues to employ unrealistically optimistic assumptions regarding  
20 employment levels, operating expenses, capital expenditures, and revenues.

21 FairPoint continues to project paying dividends well in excess of what it can earn by  
22 running the business. In essence, shareholders are demanding a dividend greater than the

1 company can earn from its assets. This is unreasonable and unsustainable behavior for a  
2 public utility company.

3 FairPoint makes no provision for funding its OPEB liabilities. The increase in these  
4 obligations under the company's most optimistic scenario represents almost two-thirds of  
5 FairPoint's total projected net income for 2008 – 2015. Under less sunny scenarios, the  
6 increase in these liabilities is greater than projected profits (much greater in two cases). These  
7 liabilities are projected to grow while the company's assets decline. FairPoint is not  
8 projecting a reasonable commitment to its employees and future retirees. It is assuming a  
9 promise made by Verizon but FairPoint may not be able to live up to this promise.

10 Further, FairPoint lacks resources to make a reasonable commitment to fund capital  
11 investments in New Hampshire and Northern New England.

12 Finally, FairPoint will be unable to withstand reasonably foreseeable adverse  
13 conditions.

14 In short, Verizon should not be permitted to abandon New Hampshire without making  
15 adequate provision for the future prospects of its customers, communities and employers.  
16 Absent a very significant increased financial commitment from Verizon, I conclude that  
17 FairPoint will not be financially fit to own and operate Verizon's New Hampshire network.  
18 The Commission, therefore, should reject the proposed stipulation and reject the proposed  
19 transaction.

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

21 A. Yes it does.



## How Verizon's \$300 Million in New Commitments (Price Reductions) Are Being Spent

(\$ Millions)

New FairPoint Hard Commitments and Contingent Exposure (Pre-Tax)	
<b>Maine</b>	
<i>Hard Commitments</i>	
\$18 million rate reductions (proportionally reduced with line losses; \$9 million in 2008); guaranteed through July 2013, assume no rate change from 2013 to 2015	\$110.0
Increased broadband investment	\$15.0
<b>Total FairPoint increased hard costs</b>	<b>\$125.0</b>
<i>Contingent Exposure</i>	
Additional debt reduction in 2012 if leverage ratio exceeds 3.6 in 2011 (one option of three available)	\$150.0
<b>Total FairPoint increased hard costs / contingent exposure from Maine stipulation / settlement</b>	<b>\$275.0</b>
<b>Vermont</b>	
<i>Hard Commitments</i>	
New DSL penetration metric (100%/50%)	\$25.0
Pole remediation	\$3.0
<b>Total FairPoint increased hard costs</b>	<b>\$28.0</b>
<i>Contingent Exposure</i>	
PEP set asides	\$37.5
Failure to meet 100%/50% target	\$9.0
<b>Total FairPoint increased contingent exposure</b>	<b>\$46.5</b>
<b>Total FairPoint increased hard costs / contingent exposure from proposed Vermont stipulation</b>	<b>\$74.5</b>
<b>New Hampshire</b>	
<i>Hard Commitments</i>	
Increased broadband investment	\$15.0
Pole remediation	\$5.0
Expenditure of Verizon cash contribution for NH	\$50.0
<b>Total FairPoint increased hard costs / contingent exposure from proposed New Hampshire stipulation</b>	<b>\$70.0</b>
<b>Other new expense increases disclosed in stipulations</b>	
Increased initial broadband investment	\$8.7
Two-month extension of TSA (per FairPoint)	\$7.0
<b>Total Other Increased Hard/Contingent costs disclosed in stipulations</b>	<b>\$15.7</b>
<b>TOTAL additional hard commitments and expenses</b>	<b>\$238.7</b>
<b>TOTAL additional contingent exposure</b>	<b>\$196.5</b>
<b>TOTAL additional costs and contingent exposure</b>	<b>\$435.2</b>

Verizon Commitments		
<b>Maine</b>		
Cash contribution to Spinco working capital		\$235.5
"Forgiveness" for Verizon's accelerated DSL spending		\$12.0
<b>Total cash and debt forgiveness contribution to FairPoint from Maine settlement</b>		<b>\$247.5</b>
<b>New Hampshire</b>		
Cash contribution for FairPoint to expend exclusively in New Hampshire		\$50.0
<b>Total cash and debt forgiveness from Verizon to FairPoint in Maine and New Hampshire</b>		<b>\$297.5</b>
Payment to the MaineConnectME Authority (not FairPoint)		\$2.5
<b>Total Verizon Commitments</b>	<b>\$300.0</b>	