

**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)

**Direct Testimony
of**

RANDY BARBER

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

PUBLIC

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1 **I. Introduction**

2 **Q. Please state your name and business address.**

3 A. My name is Randy Barber. My office address is: Suite 204, 6935 Laurel Avenue,
4 Takoma Park, Maryland 20912.

5 **Q. By whom are you employed and in what capacity?**

6 A. I am employed by the Center for Economic Organizing and serve as its president.

7 **Q. On whose behalf are you testifying in this case?**

8 A. I am testifying on behalf of the Labor Intervenors, the Communications Workers of
9 America (CWA) and the International Brotherhood of Electrical Workers (IBEW).

10 **Q. Why are the Labor Intervenors interested in this case?**

11 A. Together, they represent approximately 2,500 of the approximately 3,000 Verizon
12 employees who will be directly affected by the proposed acquisition by FairPoint
13 Communications of Verizon's Northern New England (NNE) businesses in Vermont,
14 New Hampshire and Maine. They are concerned about the financial health of their
15 employer, as well as their employer's ability and commitment to safely and reliably
16 operate and maintain the telecommunications network in Northern New England.

17 **II. Background**

18 **Q. When you were retained by the Labor Intervenors, what were you asked to do?**

19 A. I was retained by the Labor Intervenors shortly after the transaction was announced. I
20 have been asked to provide expert analysis and testimony, focusing on financial issues in
21 support of their intervention before the three state regulatory bodies.

1 **Q. Do you have experience in rendering that type of opinion as an expert witness?**

2 A. Yes. While I do not specialize in being an expert witness, I have performed that function
3 on several occasions, and I have assisted experts and attorneys in the financial and
4 analytical aspects of judicial, quasi-judicial and regulatory proceedings.

5 **Q. What in your educational and employment background has qualified you to provide
6 an expert opinion on financial issues such as those presented in this case?**

7 A. After attending Dartmouth College, I have worked as a financial consultant for more than
8 25 years. I specialize in complex financial and operational analyses of companies and
9 industries, sometimes in the context of collective bargaining, other times in support of
10 clients' strategic or policy interests. My clients tend to be labor unions and pension
11 funds. I also regularly analyze a wide range of issues impacting specific employee
12 benefit plans. Among the companies that I have analyzed in great depth are Alcatel,
13 Avaya, AT&T, Boeing, Celestica, Columbia/HCA, Eastern Air Lines, Edison Schools,
14 Lucent Technologies, MCI, Oregon Steel, Sylvan Learning Systems, Texas Air
15 Corporation, TIAA-CREF, United Air Lines, the United States Postal Service, and Wal-
16 Mart. More broadly, I have provided clients with various analyses of such industries as
17 aerospace manufacturing, air transport, for-profit education, newspaper publishing, off-
18 road vehicle manufacturers, and telecommunications and internet access and content
19 providers.

20 In addition, I have performed a wide range of analyses of private sector pension
21 plans and public employee retirement systems across the country. These include
22 investigations into factors associated with under-funding, integration of two or more
23 benefit plans, efforts to improve the operations of benefit plans, evaluations of proposed

1 investment and funding mechanisms, and proposals to convert defined benefit plans into
2 defined contribution plans. A number of the activities mentioned above have taken the
3 form of joint labor-management initiatives in which I served as the union expert, paired
4 with one or more management experts. Some of these projects included work with
5 AT&T, Lucent Technologies, and the League of Voluntary Hospitals and Nursing Homes
6 (New York City and environs).

7 **Q. Please summarize your experience as an expert financial analyst witness.**

8 A. I have testified as an expert witness (either at trial or by deposition) in several judicial
9 proceedings and arbitrations. These have included, for example, a class action law suit
10 involving BTT, National Mediation Board Single Carrier proceeding, the Big Sky
11 Airlines Bankruptcy, and an Examiner's Investigation into the Bankruptcy of Eastern Air
12 Lines. In addition, I have served as an expert consultant in various proceedings where it
13 was not necessary for me to testify, such as an airline fitness investigation involving
14 ATX, a cross-border airline merger investigation (American Airlines-Canadian Airlines),
15 and a major CWA/AT&T arbitration.

16 **III. Summary**

17 **Q. How is your testimony organized?**

18 A. My testimony is divided into two separate parts. The first is this Statement with
19 accompanying Schedules (Labor Intervenors Statement 2), which is a public document.
20 In this Statement, I will summarize my analysis and conclusions, but without disclosing
21 any information that FairPoint and/or Verizon claim to be confidential. My second
22 Statement with accompanying Schedules (Labor Intervenors Statement 3) is entirely
23 confidential and contains the details of my analysis using information that the Applicants

1 claim to be confidential, including an analysis of the FairPoint Discovery Model and
2 Synergies Model.

3 In addition, Labor Intervenors also are sponsoring the testimony of Kenneth
4 Peres, who is discussing service quality issues and making additional recommendations.

5 **Q. In order to render an opinion about the financial analyses presented by FairPoint in
6 this case, what information do you need to review?**

7 A. Ideally, I should be able review all relevant information that was available to FairPoint’s
8 and Verizon’s Boards of Directors, management, and advisors, as well as subsequently
9 developed data regarding either of the companies, the transaction, and refined projections
10 regarding the post-closing “new” FairPoint.

11 **Q. Please summarize the types of documents that you were able to review in this case.**

12 A. I have reviewed documents that fall into a number of categories:

- 13 • Press reports;
- 14 • FairPoint and Verizon filings with the Securities and Exchange Commission
15 (some dating back to the late 1990s);
- 16 • Documents from various public utility regulatory agencies;
- 17 • Documents derived from on-line databases;
- 18 • Confidential and non-confidential pre-filed testimony from the Applicants;
- 19 • Confidential and non-confidential replies (and associated attachments) to
20 information requests to the Applicants from various Intervenors;
- 21 • FairPoint’s “super confidential” Discovery Model and closely related
22 Synergies Model..

1 **Q. Before we get into the transaction itself, please describe your basic impressions**
2 **about FairPoint.**

3 A. FairPoint is a holding company that specializes in acquiring, operating, and selling small,
4 primarily rural telephone companies. It currently owns 31 operating companies that
5 provide communications services to rural and small urban communities (though it is in
6 the process of selling one of them in Illinois). As I discuss below, FairPoint pays very
7 high dividends, yielding over 8.5% at current share prices. Its dividend payments are
8 significantly more than FairPoint earns, and it relies heavily on depreciation to generate
9 the cash flows it requires to support its dividend policy and further acquisitions.

10 **Q. Based on your review and analysis, are you able to render an opinion about the**
11 **reasonableness of FairPoint's financial assumptions and analyses?**

12 A. Yes.

13 **Q. Please summarize your opinion.**

14 A. My opinion is based on three critically important factors: risk, capacity, and credibility.
15 Based on my review of those factors, I conclude that the proposed FairPoint acquisition
16 of the Verizon Northern New England properties is not in the best interests of Verizon's
17 customers or employees, or the State of New Hampshire as a whole.

18 **Q. Please summarize your analysis of the risks posed by this transaction?**

19 A. The fundamental issue is one of risk, and who bears it. While no one can foresee the
20 future, FairPoint is urging the PUC and all New Hampshire residents to rely on the company's

1 ability to accurately project the future in ways that, if they prove incorrect, could have
2 highly negative consequences.¹

3 FairPoint is a very risky holding company, specializing in acquiring, operating,
4 and selling telecommunications companies. Fundamental to its financial strategy is the
5 utilization of “free cash flow,” derived primarily from depreciation, to pay very high
6 dividends. In 2006, FairPoint’s dividends were 76% higher than its net income and its
7 dividends were roughly equal to its depreciation and amortization. FairPoint could not
8 have paid dividends without using half of its depreciation. FairPoint’s pre-tax, pre-
9 depreciation, pre-capital expenditure cash flow was about \$115 million. It expended \$32
10 million in capital expenditures, leaving about \$83 million. It paid out about \$55 million
11 in dividends (versus about \$32 million in net income), leaving about \$28 million in post
12 dividend free cash flow. However, FairPoint’s non-cash depreciation and amortization
13 charges were about \$53 million.² Thus, \$25 million of FairPoint’s \$53 million was
14 required to fund dividends.

15 FairPoint is cannibalizing itself by continually paying out more in dividends than
16 it earns. It generates the cash to do this from depreciation – taking money that should be
17 reinvested in its networks and, instead, paying it out to stockholders as a dividend. In its
18 short life as a public company, FairPoint’s shareholder equity has declined by \$57
19 million, or 21.4%, even though its net income was \$60 million for the same period.³ That
20 is, in the last two years, FairPoint has paid dividends equal to nearly twice its level of net
21 income.

¹ I address this issue at some length in my Confidential Statement.

² FairPoint Communications, SEC Form 10K, 2006

³ Schedule RB-8

1 I call this cannibalization because FairPoint is quite literally eating itself alive.
2 FairPoint's strategy is extremely risky and can continue for only so long. In order to
3 sustain FairPoint's approach to business, it must continually acquire new companies and
4 use the depreciation-based cash flows from those new companies to provide the cash to
5 support its high payments.

6 In other words, FairPoint's approach to business is to invest as little as possible in
7 capital plant and siphon the rest of the cash out of the operating companies to support its
8 extraordinarily high dividend payment. It is clear to me that FairPoint's business model
9 relies on the acquisition of companies with depreciable assets that can be used to support
10 FairPoint's dividend payments, some amount of debt retirement, and acquisition of
11 additional properties (with additional depreciable assets). With a business model such as
12 this, it is imperative to restrain capital expenditures, since they compete with dividend
13 payments, debt reduction and additional acquisitions, particularly when dividend
14 payments are first among equals in the competition for corporate resources. It is not
15 sustainable to continually pay out more in dividends than the company earns in net
16 income.

17 While it touts its investment and operational plans, FairPoint's strategy is really
18 keyed to generating cash flow then using that cash to pay interest on its debt and
19 dividends to stockholders. If its projections prove to be over-optimistic and its results
20 materially suffer, FairPoint will need to adjust by squeezing its employees'
21 compensation, raising prices, permitting service to deteriorate, reducing investment,
22 cutting dividends, or, more likely, a combination of these. The impact of such actions is
23 likely to be devastating to New Hampshire.

1 **Q. Does FairPoint have the ability to successfully execute this transaction?**

2 A. I believe that there are significant risks that FairPoint will not have the ability to
3 successfully undertake a transaction of this magnitude. I base my conclusion on
4 FairPoint's history, the fact that Verizon needed to provide \$95 million of FairPoint's
5 projected \$110 million in pre-closing costs,⁴ the fact that Capgemini is deferring \$15
6 million in pre-transaction billing, and the fact that this transaction is fundamentally unlike
7 anything FairPoint has attempted in the past. Not only are FairPoint's 31 operating
8 subsidiaries minuscule in comparison to the Verizon Northern New England properties,
9 they all enjoy significant subsidies and guaranteed returns on their investments.

10 There is nothing in FairPoint's history that would lead one to believe that it has
11 the expertise or financial resources to successfully integrate a large, complex, multi-state
12 telecommunications network like Verizon's NNE operations. Indeed, in order to try to
13 do so, FairPoint needed to hire an outside consultant to create dozens of new systems
14 from scratch to replace more than Verizon's 600 separate systems. FairPoint's existing
15 systems (such as billing) were not adequate to handle the NNE operations, plus it
16 completely lacked other essential systems (such as network operations on this scale,
17 CLEC interfaces, E911 services, operator services, among many others).

⁴ As part of this transaction, Verizon paid FairPoint \$55 million for FairPoint's interest in a cellular telephone partnership in New York. In addition, Verizon is paying \$40 million of FairPoint's pre-closing transition costs.

1 **Q. FairPoint has suggested that it could have entered into this transaction even**
2 **without the \$40 million in direct support from Verizon, the \$55 million in cash that**
3 **it obtained from selling the cellular partnership to Verizon Wireless, and the \$15**
4 **million in deferred billing from Capgemini. Do you concur?**

5 A. I think that is highly unlikely for the following reasons:

6 1. At the time of the transaction, FairPoint had approximately \$84 million
7 available from its revolving credit facility, about \$36 million shy of the projected \$110
8 million in pre-closing costs.

9 2. While FairPoint might in theory have been able to obtain additional funds,
10 either by increasing the credit available through the revolver or from another source, it
11 would have confronted the prospect not only of breaching its covenant-driven leverage
12 ratio for paying dividends but it would have violated a key covenant in its indebtedness.

13 As can be seen in the table below, FairPoint's "Leverage Ratio" covenants were a
14 maximum of 5.00:1.00 for continued payment of dividends and 5:25:1:00 to remain in
15 compliance with the covenants of FairPoint's indebtedness.

Covenant Leverage Ratio "Triggers" in Effect at the time of the transaction	
Suspension of Dividends	5:00:1.00
Covenant Non-Compliance	5:25:1:00

16
17 As can be seen below, if FairPoint were able to borrow an additional \$110 million
18 to fund the transaction itself, its Leverage Ratio would have risen from 4.58:1.00 to
19 5.42:1.00, not only forcing it to suspend dividend payments but also violating a key
20 covenant ratio and placing it in at least technical default on its indebtedness.

	Adjusted EBITDA (Millions)	Net Debt (Millions)	Leverage Ratio (Net Debt-to-Adjusted EBITDA)
FairPoint, Year-End 2006	\$131.3	\$602.0	4.58
FairPoint with \$110 million in new debt	\$131.3	\$712.0	5.42

1
2 Of course, it is possible that FairPoint might have been able to convince its
3 lenders to raise the leverage ratio triggers, as it subsequently did after the transaction was
4 signed and including the \$110 million in pre-closing funds and forbearance. However,
5 that seems unlikely in the overall context of this transaction, where FairPoint was already
6 going to be stretched very thin in making the deal work under the original terms.

7 3. It is also important to note that the threat – or certainty – of a freeze on
8 dividend payments would have almost certainly resulted in a steep decline of FairPoint’s
9 stock price. That in turn would have reduced the value of the 53.8 million new FairPoint
10 shares that the company planned on using as “currency” in the transaction (valued at
11 \$1.015 billion based on FairPoint’s then-prevailing share price). Without speculating
12 about the magnitude of a FairPoint stock decline in the face of suspended dividends, I
13 would simply note that for every \$1 that FairPoint’s stock declined below the
14 transaction’s \$18.88 implied value of the company’s shares, FairPoint would lose about
15 \$54 million in company stock “currency” that could be used in the transaction.⁵

⁵ Indeed, after an initial increase, FairPoint’s stock price has declined rather steadily. FairPoint’s final SEC form 424(b)(3) Prospectus, filed on July 19, 2007, for the first time quantified the projected reduction in value to Verizon shareholders. Relying on the \$17.20 closing price of FairPoint stock on July 12, 2007, the company revised its estimate of the approximate value Verizon stockholders will receive in the merger to \$936 million (this projection was based on a slightly greater number of shares to be issued, 54.1 million versus the initially forecast 53.8 million). Of course, the actual value to Verizon shareholders will not be known with certainty until (and if) the transaction closes. For example, FairPoint’s closing stock price on July 21 was \$17.07, further reducing the implied value to Verizon shareholders to about \$924 million (more than \$90 million below the initially projected \$1.015 billion).

1 **Q. The third point you highlighted is credibility. How do you assess FairPoint's**
2 **credibility?**

3 A. There's an old saying: "Watch what someone does, not what they say." FairPoint is
4 making a lot of promises, all based on a series of assumptions. Among the most critical
5 of these assumptions is that, initially, it can successfully eliminate eight to ten percent of
6 NNE's operating expenses. FairPoint projects it will achieve \$60 to \$75 million in cost
7 reductions by replacing expenses allocated to NNE by Verizon for "back office" and
8 other network system services with its own newly created systems and functions.
9 FairPoint intends simultaneously to absorb about 1.5 million customers and replace the
10 backbone operational and business systems that serve them. This is an enormously
11 challenging task, one far beyond anything FairPoint has attempted in the past. In fact, I
12 believe that it is unprecedented for any telecommunications firm to attempt such a task on
13 this order of magnitude.

14 While I address this issue in more depth in my Confidential Statement,
15 FairPoint's own public track record with respect to controlling operating costs is far from
16 reassuring, as I discuss below.

17 There is nothing in FairPoint's history that would lead us to believe that it can
18 somehow magically reduce Verizon's expenses by \$60 to \$75 million. Indeed,
19 FairPoint's existing operations have per-access-line operating costs that are much higher
20 than the NNE properties' costs – on average \$108 per access line (17.3%) more than
21 Verizon's NNE average costs over the past five years.⁶ As I discuss later, further
22 analysis of FairPoint's history shows that its operating costs continue to increase at a rate

⁶ Schedule RB-3.

1 faster than inflation. This stands in stark contrast to FairPoint's statements that not only
2 can it reduce Verizon's costs initially, but that it can continue to decrease those costs in
3 the future. It is projecting that it will be able to achieve one-time operating expense
4 reductions of 22% to 34% in back office, network and other related expenses, and at the
5 same time hold down the increase in unit operating costs to levels well below FairPoint's
6 own historic performance. This is simply not credible.

7 **Q. But wouldn't you expect FairPoint's per-line operating costs to be higher than**
8 **Verizon's, since FairPoint operates mostly in rural areas?**

9 A. All things considered, I would expect unit operating costs to be higher in rural areas than
10 in the mixed rural/suburban/urban areas served by the Northern New England operations.
11 However, I believe that the rate of increase in these costs would not necessarily depend
12 on the rural or urban character of the utility. FairPoint's five year increase in per-unit
13 operating costs of 17.3% is not indicative of a company that has learned how to restrain
14 expenses, even though its existing operations are far less complicated than NNE.

15 **Q. Do you also doubt the credibility of FairPoint's statements that it can make this deal**
16 **work from a financial perspective?**

17 A. Yes, I do. FairPoint makes much of how this transaction will allegedly improve its
18 financial structure and dividend-paying capacity. But that projection is based on the
19 dubious premise that FairPoint can cut Verizon's back-office expenses by nearly one-
20 third. As I discuss elsewhere, if we accept everything else FairPoint says (which I
21 certainly do not), just changing that one assumption completely undercuts FairPoint's
22 financial projections.

1 Moreover, even with FairPoint’s faulty assumption about expense reductions,
2 FairPoint’s financial model “works” only if it continues to pay out substantially more in
3 dividends than it earns in net income. Thus, if FairPoint and Verizon had been combined
4 in 2006, FairPoint would have paid out \$141 million in dividends, but the combined
5 company would have earned just \$37 million in net income.⁷

6 **Q. In your Confidential Testimony, you discuss the FairPoint financial model⁸ to which**
7 **you were recently given access. Without disclosing any allegedly confidential**
8 **information, please describe your conclusions about this model.**

9 A. As a tool for evaluating alternative assumptions – or simply to incorporate updated
10 information – the FairPoint financial model is extraordinarily cumbersome. It contains a
11 huge number of “hard coded” numbers, many of which should – but do not – change
12 when other parts of the model are altered. Many of these hard coded numbers contain up
13 to thirteen decimals (far beyond what I believe would be coded by hand), indicating that
14 they were placed there by some sort of computer operation. The model also contains
15 hundreds of cells with formulas that include hard coded numbers, sometimes as part of
16 the addition of multiple numbers, other times imbedded as part of more complex
17 computation routines.

18 As provided to me, this is not actually a model in the sense that I believe most
19 analysts would understand the term; for example, it is not capable of performing
20 “sensitivity analyses” to test various simple or complex scenarios. While it may contain
21 FairPoint management’s views (or assumptions or hopes) regarding the prospects of the

⁷ Schedule RB-3.

⁸ Referred to by FairPoint as the Discovery Model

1 NNE transaction, I believe that even an experienced user would have significant
2 difficulties using it to test alternatives, make changes in many assumptions, or reflect
3 updates for new data.

4 Overall, my impression of the Discovery Model is of a large, complex jigsaw
5 puzzle, with some of the pieces already glued to the table.

6 **Q. Based on these three key factors – risk, capacity, and credibility – what do you**
7 **conclude about the proposed transaction?**

8 A. In summary, based on the size and complexity of the transaction, FairPoint’s
9 demonstrated inability to reduce operating expenses on a per-access-line basis, and its
10 heavy reliance on depreciation-based dividend and debt retirement strategies, among
11 other considerations, I conclude that the proposed FairPoint acquisition of the Verizon
12 Northern New England properties poses unacceptably high risks. Those risks are posed
13 not only to FairPoint itself, but to the customers, employees, communities and economies
14 that rely upon Verizon’s telecommunications network in New Hampshire.

15 **IV. The Proposed Transaction**

16 **Q. What is your understanding of the proposed transaction?**

17 A. While there are multiple elements and steps, Verizon and FairPoint have agreed to a
18 transaction that would result in the spin off to Verizon shareholders of Verizon’s
19 regulated wireline businesses and certain non-regulated businesses in Vermont, New
20 Hampshire, and Maine (referred to as “Spinco”)⁹ and immediately following merger of
21 Spinco into FairPoint. In exchange for the Spinco shares, FairPoint would issue new

⁹ Throughout this Statement, I refer to Spinco, Northern New England properties or businesses, or NNE interchangeably.

1 FairPoint shares to Spinco shareholders. After the transaction is consummated, Verizon
2 shareholders would own approximately 60% of FairPoint, which the parties have valued
3 at slightly more than \$1 billion (based on the price of FairPoint’s stock prior to the
4 announcement of the proposed transaction). Verizon would receive approximately \$1.7
5 billion in consideration, in the form of a special dividend from Spinco and newly issued
6 Spinco debt. The special dividend of about \$900 million would be in the amount of
7 Verizon’s tax basis in Spinco and would be funded by new Spinco borrowings
8 immediately prior to the spin off. The new Spinco debt of about \$800 million would be
9 designed to be exchanged by Verizon for existing Verizon debt. The “new” FairPoint
10 would thus absorb Spinco’s assets and liabilities. The transaction has been designed to
11 be tax-free to Verizon and its shareholders, with Verizon saving a reported \$600 to \$700
12 million in taxes.¹⁰

13 **Q. What is your overall impression of the proposed transaction?**

14 A. The proposed transaction appears to me to have several quite unusual elements and to
15 have significant structural and execution risks. FairPoint is proposing to acquire business
16 assets that, depending on how one measures it, are 3.2 to 6.1 times larger than it. The
17 latter ratio compares the access lines that FairPoint is contributing (14%) and those that
18 Verizon NNE is contributing (86%), and seems to me to be the most important metric,
19 reflecting the actual relative size of the companies’ operations.¹¹ This alone raises
20 serious questions in my mind about the risks associated with the proposed transaction.

¹⁰ See Pre-Filed Direct Testimony of Verizon Vice President Stephen E. Smith, pp. 10, 16-17; also see Pre-Filed Direct Testimony, Michael J. Balhoff, pp. 13-14

¹¹ See Schedule RB-1

1 I am also very concerned about financial terms of the proposed deal, with NNE
2 acquiring \$1.7 billion in new debt (which will either be paid to Verizon in cash as a
3 special dividend or issued to Verizon as new NNE/FairPoint long-term debt). Of even
4 more concern, in my view, are the very aggressive cost-cutting “synergies” that are key to
5 FairPoint’s post-closing operating plan. Specifically, FairPoint is projecting that it would
6 achieve an eight to ten percent (\$60 to \$75 million) reduction in operating expense within
7 a year after closing. What makes these cost-savings assumptions even more aggressive,
8 in my view, is that they were to come out of Verizon’s \$240 million in “back office” and
9 network allocations to NNE.¹² This implied that FairPoint thinks it will be able to replace
10 these functions and save between 25 and 31 percent in the process. If achieving this goal
11 is critical to the success of FairPoint’s plans, there are some real risks to NNE’s
12 constituents inherent in the deal.

13 Further, while Deutsche Bank has delivered a “fairness opinion” to FairPoint’s
14 Board of Directors, Deutsche Bank explicitly “expressed no view as to the
15 reasonableness of these forecasts and projections, including the synergies, or the
16 assumptions on which they were based.”¹³ This means that, from the perspective of
17 evaluating FairPoint’s model and the projections it produces, no confidence can be placed
18 in the fact that FairPoint received a fairness opinion from one of its investment advisors.

19 Because of the structural and execution risks inherent in the transaction, it
20 appears to me that employees, customers, communities, and Verizon and FairPoint

¹² While FairPoint initially stated that it planned to save \$60 to \$75 million in synergies to be gained by replacing Verizon’s allocations to NNE, FairPoint’s subsequent April 3, 2007 SEC Form S-4 filing indicated that the back office allocations during 2006 had actually been \$270 million, although the \$60 to \$75 million target remained unchanged.

¹³ FairPoint SEC Proxy/Prospectus of July 19, 2007, p. 67.

1 shareholders would be subject to various potential risks that could be quite significant.

2 There is structural risk, in my view, because of the relative size and complexity of the
3 FairPoint and NNE operations, and there is execution risk because FairPoint must
4 implement its plan more-or-less flawlessly.

5 In a February 2007 conference call with investment analysts, FairPoint Chairman
6 and CEO, Frank Johnson, acknowledged the central importance of FairPoint's ability to
7 implement its plan: "Obviously, we know that the company is going to be largely judged
8 by how well we execute over the next 12 to 18 months, predominantly in New England,
9 but also in our existing core business. It is a valid expectation . . ." ¹⁴

10 The risks associated with this transaction could result in potential and very
11 significant negative consequences that would vary by constituency. For example:

- 12 • employees could be subject to job loss, changes in the working environment,
13 wage reductions, and the reduction or elimination of current or prospective
14 benefits;
- 15 • customers could be subject to rate increases, service degradation, and limited
16 service offerings resulting from reduced operating, maintenance and capital
17 expenditures;
- 18 • communities could be subject to limits on future growth and the economic
19 impact of rate increases and reduced jobs, wages and benefits;

¹⁴ FairPoint SEC Form 8K, February 23, 2007; February 21, 2007 transcript of the 4th Quarter 2006 Earnings Conference Call

- 1 • Verizon shareholders could be subject to reduced value of their holdings in the
2 FairPoint shares that they would be issued (without their approval, I would
3 add); and,
- 4 • FairPoint shareholders could also be subject to reduced value in their
5 FairPoint holdings, and they could end up owning a company (FairPoint) that
6 is very different from the one they bought.

7 **Q. As you learned more about the proposed transaction, did your opinion of it change?**

8 A. I have focused my analysis on understanding how this transaction affects my clients'
9 members, as well as other constituencies of which they are a part. As mentioned
10 immediately above, my overall impression is that this is a very problematic transaction
11 that poses varying risks to different constituencies. However, my task in the context of
12 this proceeding is to test that impression by evaluating all of the available data and to
13 base my analysis on that data, wherever it might lead.

14 If the data and arguments presented by the Applicants refuted my initial concerns,
15 I would report as much. However, the public and confidential data and statements
16 supplied by the Applicants have only served to reinforce, even expand, my initial
17 concerns about the risks attendant with this transaction.

18 **V. Detailed Analysis Using Public Data**

19 *A. Introduction and Identification of Schedules*

20 **Q. Have you conducted a detailed, financial analysis of the proposed transaction?**

21 A. Yes, I have. I have reviewed virtually all documents that have been submitted to-date
22 and performed analyses of those that appeared most relevant to the financial aspects of

1 the transaction. I would note that some key documents were submitted only very
2 recently.

3 **Q. In your summary, you referred to various schedules you prepared. Please identify**
4 **each schedule, and briefly explain why you prepared it and what you believe it**
5 **demonstrates.**

6 A. I have prepared 13 schedules based on public data. I will briefly describe each schedule
7 and explain why it is an important part of my analysis.

8 **Schedule RB-1: Relative Contributions to the Post-Transaction New FairPoint**

9 This schedule compares the relative contributions of FairPoint and Verizon
10 Northern New England to the proposed combined companies. As I have mentioned, I
11 have been concerned from the beginning with the relative size and complexity of the two
12 entities, and this Schedule evaluates some of the key ratios. Schedule RB-1 shows that
13 Verizon NNE is significantly larger than FairPoint by any measure.

14 **Schedule RB-2: Comparative FairPoint 2006 and Pro Forma Per Share Data**

15 A striking feature about FairPoint is its very high dividends, particularly since its
16 2006 dividends were 77% greater than its net income. Schedule RB-2 reflects both
17 FairPoint's 2006 dividend and book value per share data. It also presents the same data
18 for the combined companies (FairPoint plus Verizon NNE) on a 2006 pro forma basis
19 (including the impact of adjustments that FairPoint made to the income and balance sheet
20 statements). Schedules RB-3, RB-4 and RB-5 also reflect calculations derived from the
21 2006 pro forma statements.

22 **Schedule RB-3: 2006 Dividends as a Percent of Net Income: Verizon, FairPoint,**
23 **Combined FairPoint/NNE Pro Forma**

1 Schedule RB-3 compares the 2006 dividends paid by Verizon and FairPoint as a
2 percent of the companies' net income, as well as the same measure for the pro forma
3 combined FairPoint-NNE. As subsidiaries of Verizon, the NNE businesses effectively
4 participated in Verizon's 76% dividend-to-net income payout ratio. Whether the
5 combined companies ever actually pay 381% of their net income in dividends, it is clear
6 that the Northern New England properties will be expected to provide significantly higher
7 cash flows in support of FairPoint's dividend policy.

8 **Schedule RB-4: Comparative 2006 Debt-to-Equity Ratios**

9 There are many measures used to evaluate a company's financial strength and
10 borrowing capacity. One of the most widely used is the debt-to-equity ratio. Schedule
11 RB-4 reports this measure for Verizon, FairPoint and the pro forma 2006 combined
12 FairPoint/NNE. As can be seen, FairPoint's 2006 debt-to-equity ratio was about four and
13 one-half times higher than Verizon's, while the 2006 pro forma combined FairPoint/NNE
14 debt-to-equity ratio is almost triple FairPoint's and over thirteen times Verizon's.

15 FairPoint and Verizon sometimes refer to the combined FairPoint/NNE's
16 "Debt/Equity," which compares the combined companies' projected debt with the
17 projected total stock market value of the combined firms.¹⁵ This is not the metric
18 normally associated with debt-to-equity ratios. A debt-to-equity ratio is a measure of a
19 firm's total long term debt to the shareholder equity on its balance sheet.¹⁶ More
20 importantly, the ratio that the Applicants advance is of no use in evaluating a company's

¹⁵ Leach, A.DPS:FP.2-26 (Vermont), who argues that "a 63%/37% debt/equity ratio is a very reasonable capital structure" using the debt to projected market value metric.

¹⁶ "LT Debt to Equity is calculated as: Long Term Debt / Common Equity . . . LT Debt to Equity is a measure of a company's financial leverage, and indicates what proportion of equity and debt that the company is using to finance its assets." Thompson Financial, Via AOL; visited 5/15/07

1 capital structure. While share prices reflect investor confidence in a firm (or in
2 FairPoint's case, the attractiveness of very high dividend yields), they cannot be used to
3 measure the internal balance between borrowings and retained earnings plus contributed
4 capital that is the basis of determining relative leverage.

5 **Schedule RB-5: Merger's Impact on Combined Companies' Balance Sheets, Pro**
6 **Forma, as of 12/31/06**

7 As I have noted in discussions of Schedules RB-2, RB-3, and RB-4, FairPoint
8 issued pro forma income and balance sheet statements for the combined FairPoint/NNE,
9 as of year-end 2006. Schedule RB-5 presents data derived from the combined
10 companies' pro forma balance sheet. I have replicated FairPoint's data, adding three
11 additional columns of calculations. The additional columns present the sum of the two
12 entities' year-end 2006 balance sheets (before the pro forma adjustments), and the
13 difference for each line item between the unadjusted totals and adjusted pro forma
14 calculations, on a dollar and percentage change basis. I recognize that there is a lot of
15 information presented in this schedule, but I believe that it can serve as a useful roadmap
16 to understand FairPoint's proposed capital structure and its underlying financial viability.

17 **Schedule RB-6: FairPoint vs. Verizon Operating Expenses per Access Line**

18 Schedule RB-6 reports computations of the operating expense per access line (or
19 unit cost) for FairPoint and Verizon NNE over the five-year period for which comparable
20 data are available. The schedule then compares the difference in these costs for FairPoint
21 and Verizon NNE, on a dollar and percentage basis. The results are compelling on a
22 number of levels. FairPoint's absolute costs per access line are significantly higher than
23 Verizon NNE's (\$108 or 17.3% higher on average). While FairPoint's reported increase

1 in per access line cost grew at a slightly slower rate than NNE (27.2% vs. 30.6% over the
2 five year period), FairPoint's average cost in 2006 may be somewhat distorted by two
3 factors: it added 13,200 access lines via three acquisitions during the second half of
4 2006, and FairPoint began including an undisclosed number of lines from its CLEC
5 subsidiaries beginning with the quarter ending September 30, 2006. The new access lines
6 added later in 2006 account for 6.3% of FairPoint's reported year-end total. Since these
7 newly acquired lines' operating expenses were included for less than six months, the
8 acquisitions artificially reduced FairPoint's reported operating expense per access line
9 somewhat.

10 Still, it is clear that FairPoint's unit costs are not only higher than NNE's (a
11 reported \$111 higher in 2006), they have been increasing at roughly the same rate over
12 the past five years as well.

13 FairPoint's demonstrated inability to drive down operating expenses is an
14 important factor to take into account when evaluating the credibility of FairPoint's
15 projections that it will be able to *reduce* NNE's operating expenses by eight to ten
16 percent – from allocated back office and network expenses – within a year after the
17 transaction closes.

18 In addition, Schedule RB-6 lets us evaluate the growth trend in operating
19 expenses, which is an additional challenge that FairPoint will confront. During the 2002-
20 2006 period, FairPoint acquired five companies with about 33,000 access lines (in 2003,
21 2005 and 2006) but FairPoint's unit costs have continued to rise. FairPoint has not
22 demonstrated an ability to drive down unit costs, or even hold their growth materially
23 below the levels experienced by NNE. Based on FairPoint's historic performance,

1 applied to NNE's 5-year operating expense trends, one would predict that the *imbedded*
2 rate of increase for NNE's operating expense per access line would be largely unaffected.
3 Put another way, it seems reasonable to conclude that FairPoint will inherit an annual
4 NNE unit operating expense growth rate of about 6% to 7%. There is no reason to
5 believe that FairPoint will be able to do for NNE something it has not been able to do for
6 its own operations.

7 **Schedule RB-7: FairPoint: Quarterly Change in Per Access Line Operating**
8 **Expense, 1Q06-1Q07**

9 Schedule RB-7 carries my analysis of FairPoint's operating expense per access
10 line forward to the 1st quarter of 2007, using quarterly financial statements from the
11 March 2006 quarter through the March 2007 quarter (comparable data for NNE is not as
12 yet available). This schedule reveals that FairPoint's unit operating expenses appear, if
13 anything, to have accelerated. During this twelve month period, FairPoint expended \$8.0
14 million on activities related to this transaction. I have reduced operating expenses by the
15 amounts of such expenditures for the last two quarters. Even after this adjustment,
16 FairPoint's unit operating expense increased by 8.1% for the twelve months ending
17 March 31, 2007.

18 **Schedule RB-8: Changes in FairPoint's Shareholder Equity Since Its 2005 IPO**

19 Another disturbing feature of FairPoint's financial operations is the fact that, since
20 its early 2005 Initial Public Offering, it has paid out significantly more in dividends than
21 it has earned. As a result, FairPoint's shareholder equity has declined steadily since its
22 IPO: a \$57 million or 21.4% decline in just two years. Schedule RB-8 tracks the decline
23 in FairPoint's shareholder equity.

1 **Schedule RB-9: FairPoint Net Income, Depreciation, Dividends and Capital**

2 **Expenditures, 2002-2006**

3 My analysis of FairPoint’s business model reveals another source of potential risk
4 for NNE and its constituents. FairPoint is focused first and foremost on *cash flows*. Of
5 course, net income is important, but FairPoint appears to pay much more attention to free
6 cash flow, which is net income plus depreciation less capital expenditures.¹⁷ As I explain
7 below, FairPoint relies on depreciation – which is a non-cash charge against income – to
8 fund its high dividend level and, it would appear, its acquisitions. This is problematic
9 since depreciation is an accounting convention that permits companies to fund the
10 replacement of worn out or obsolete capital assets. However, FairPoint is using
11 depreciation as a “bank” to fund dividends.¹⁸

12 Schedule RB-9 reflects FairPoint’s net income, depreciation, dividends and
13 capital expenditures for the five year period 2002-2006 and calculates certain ratios.¹⁹ As
14 can be seen, capital expenditures as a proportion of depreciation have declined by more
15 than a quarter, from 84% in 2002 to 61% in 2006. In 2006, FairPoint’s dividends were
16 71% higher than its capital expenditures and 78% higher than its net income. In other
17 words, the value of FairPoint’s asset base is shrinking – it is recovering more in
18 depreciation expense than it is spending to replace (or upgrade) its capital plant. This
19 schedule shows that FairPoint’s approach to business is to invest as little as possible in
20 capital plant and siphon the rest of the cash out of the operating companies to support its

¹⁷ Many companies also include one-time or extraordinary items in measuring their free cash flow, but FairPoint routinely excludes these items, since its debt covenants permit various adjustments that FairPoint carries through to its supplemental measures such as free cash flow.

¹⁸ Since money is fungible, it is not possible to track the exact usage of depreciation; it is also certainly possible that FairPoint uses, or plans to use, depreciation to repay some debt and provide an operating cushion.

¹⁹ FairPoint only began to pay dividends to common equity subsequent to its early 2005 IPO.

1 extraordinarily high dividend payment. It is not sustainable to continually pay out more
2 in dividends than the company earns in net income.

3 The risks of this transaction to various NNE constituents will increase markedly
4 to the extent that these calculations reflect FairPoint's post-transaction business model.

5 **Schedule RB-10: FairPoint Revenue and Access Line Growth: 1998-2006**

6 As I describe below, FairPoint's rapid early growth basically came to a halt at
7 about the same time that it was forced to discontinue its ill-fated CLEC venture. Since
8 then, FairPoint's growth, measured by revenues and access lines has been quite modest at
9 best. Schedule RB-10 graphs FairPoint's reported revenues and access lines from 1998
10 through 2006. This is not a picture of a growing company, but rather of one that is
11 basically treading water. FairPoint styles itself as a holding company that is engaged in
12 acquisitions, sales, and subsidiary operations. While it has acquired a handful of local
13 telephone companies over the past few years, they have been very small in comparison to
14 FairPoint's total portfolio of companies, and absolutely minuscule in comparison to
15 NNE. Operationally, FairPoint has done nothing to distinguish itself from Verizon NNE
16 in terms of efficiencies and reduced unit costs. Put another way, FairPoint is not nearly
17 the robust and dynamic company that it represents itself to be.

18 **Schedule RB-11: Selected FairPoint Financial Projections: 2008 - 2015 (as of**
19 **January 2007)**

20 Schedule RB-11 compiles key financial projections for the combined
21 FairPoint/NNE operations from 2008 to 2015, as disclosed by FairPoint in multiple SEC

1 filings.²⁰ In my experience, it is exceedingly rare for a company to publicly disclose
2 transaction-related financial projections with the level of detail or over the period of time
3 included in these filings. However, they are similar-to-identical to the confidential data
4 and projections that FairPoint and its advisors generated in early January 2007 and that
5 have been produced by FairPoint in these proceedings.²¹

6 The projections and data in RB-11 were provided by FairPoint to its investment
7 advisor, Deutsche Bank, which in turn relied upon them in rendering its fairness opinion
8 to FairPoint's Board of Directors on January 15, 2007 (the meeting at which FairPoint's
9 Board approved the Verizon Northern New England transaction). In its July 19, 2007
10 Proxy/Prospectus filing, Fairpoint states:

11 “These financial projections were prepared in January 2007, based solely
12 on information available at that time, by FairPoint's management. While
13 the financial projections were prepared in good faith, no assurance can be
14 given regarding future events. In addition, the financial projections do not
15 reflect FairPoint's current view on the business of the combined
16 company.” (p. 74)

17 Despite this disclaimer, the projections and data extracted from these disclosures
18 for RB-11 were “prepared by, and [are] the responsibility of, FairPoint's management.”
19 Clearly, they reflected management's view at the time that the FairPoint Board approved
20 the transaction. They were also the most up-to-date information available to the FairPoint
21 Board of Directors as it considered the proposed transaction.

²⁰ These data were first disclosed on May 25, 2007 in an amendment to FairPoint's SEC Form S-4. They were included in subsequent amendments and in FairPoint's SEC Form 424B3 (final Proxy/Prospectus), July 19, 2007, pp. 74-84; "Material Projected Financial Information Provided to Deutsche Bank, Financial Advisor to FairPoint"

²¹ There are minor differences among various sets of projections and data that FairPoint has provided and that were produced shortly before the January 15, 2007 transaction agreement. FairPoint attributes these differences to evolving assumptions, updated data, and analytical techniques.

1 The importance of these projections cannot be overstated. Even though FairPoint
2 says they no longer represent the company’s updated view of the transaction, the fact
3 remains that these were the projections that FairPoint’s Board of Directors relied upon in
4 approving the transaction. Based on my review of FairPoint’s “highly confidential”
5 financial model and other information provided in this proceeding, I have verified that the
6 company’s January 2007 financial projections for the transaction have been updated and
7 materially changed. However, while some computations and ratios have been adjusted,
8 the company’s basic plan remains fundamentally unaltered.²²

9 In Schedule RB-12, discussed below, I focus on what I believe to be some telling
10 financial ratios derived from RB-11, but I will comment on two specific measures here.

11 The first is an item called “Pension & OPEB Cash Adjustment.” The acronym
12 OPEB stands for “Other Post Employment Benefits,” and my understanding is that it is
13 almost completely comprised of retiree health care obligations. The reason for the “Cash
14 Adjustment” is that, while FairPoint will incur annual pension and OPEB expenses, it
15 will initially be required to pay out little if any *cash* on these expenses. The reason for
16 this is that FairPoint will only accept financial responsibility for active NNE employees
17 at the time that the proposed transaction closes. While FairPoint will be required to fund
18 its pension obligations as they are incurred, the OPEB expenses are completely unfunded

²² The financial model which I was provided on July 2, 2007, is itself “frozen” in time. Referred to as the “Discovery Model” (because FairPoint was required to produce it during the “discovery” process in these proceedings), it does not contain FairPoint projections subsequent to April 19, 2007, when a confidential partial print version of the model was provided in another proceeding. The results displayed in this printout are identical to those in the Discovery Model. The 20-page document containing identical detailed FairPoint financial projections (CFPNH0001-0019), was first confidentially disclosed in the Vermont proceedings and is referred to there as Attachment FP:DPS.1-86. The Labor Intervenors and others are continuing to press FairPoint for updated financial information and projections, but the Discovery Model remains the most up-to-date comprehensive set of projections that the company has provided.

1 and are only payable when an eligible participant retires. FairPoint may have some non-
2 cash pension expenses (due to accounting and actuarial conventions), but most of the
3 Pension & OPEB Cash Adjustment is certainly attributable to retiree health care benefits.
4 For the 2008 – 2015 period, FairPoint projected (in January 2007) that it would make
5 \$257 million less in Pension & OPEB cash payments than it actually would incur.²³ I
6 would note that this amount is roughly comparable to FairPoint’s projected \$289 million
7 “Cash Flow After Dividends” for the same period.

8 The difference between the expenses FairPoint recognizes on its income statement
9 and the cash that it projects it will actually pay out in any particular year is reflected in a
10 cash adjustment on its statement of cash flows (as non-cash expenses). This amount is
11 also booked as a future liability on the company’s balance sheet.

12 This leads me to my second comment on this schedule. The projections that
13 FairPoint management prepared for the Board of Directors reflected Total Shareholders’
14 Equity “going negative” in 2013 and falling to a \$218 million deficit in 2015.²⁴

15 A projected negative shareholder equity is one of many reasons that I believe the
16 Commission should be deeply concerned about the risk inherent in this proposed
17 transaction. FairPoint has demonstrated that it is “focused like a laser” on cash flows. As
18 I argue elsewhere, it relies on depreciation to fund its high-yield dividend policy and it
19 doesn’t seem particularly concerned that it pays far higher amounts in dividends than it
20 earns in profits. The above-mentioned Pension & OPEB Cash Adjustment is a non-cash

²³ No information was provided about subsequent cash payments to fund previous years’ expenses for the 2008-2015 period reflected in FairPoint’s Proxy/Prospectus. Thus, the \$257 million total cash adjustment is probably somewhat greater than the net non-cash impact of this item.

²⁴ FairPoint’s shareholder value has already eroded by \$57 million or 21%, from its early 2005 Initial Public Offering through March 30 2007

1 expense just like Depreciation and Amortization. However, Pension & OPEB liabilities
2 are obligations that must be repaid in the future. At some point, FairPoint will likely find
3 itself in a position where the required payouts from past non-cash Pension and OPEB
4 expenses will become material, eventually exceeding its new Pension & OPEB cash
5 adjustments. As mentioned above, the non-cash pension expenses are likely to be both
6 transient and minor compared to the very large and unfunded OPEB expenses and future
7 liabilities. My concern is that once FairPoint is confronted with actually paying its OPEB
8 obligations, it will seek ways to avoid paying them (or at the very least, continue to incur
9 new such obligations). It is my understanding that, absent specific contractual
10 requirements such as might be contained in a collective bargaining agreement, companies
11 are free to reject – walk away from – unfunded OPEB obligations such as retiree health
12 care benefits. With a projected \$218 million negative shareholders' equity (in the
13 January 2007 projections) and looming OPEB payment requirements, I believe that
14 FairPoint would be tempted to find ways to avoid ever having to make good on these
15 obligations.

16 **Schedule RB-12: Selected Summary Metrics from FairPoint Financial Projections:**
17 **2008 - 2015 (as of January 2007)**

18 This schedule relies on data reported in RB-11 (which in turn relies on FairPoint
19 management financial projections made in January 2007). I extracted the projected 2008
20 – 2015 totals from four key financial metrics: Net Income / (Loss), Dividends Paid to
21 Common Stockholders, Depreciation and Amortization, and Pro Forma Combined Capital
22 Expenditures. I then make four computations which I believe highlight the potential
23 riskiness of the proposed transaction. These computations reveal that, at the meeting at

1 which FairPoint’s Board of Directors approved the transaction, FairPoint management
2 was projecting the following:

- 3 • Over the period 2008-2015, FairPoint would pay 4.6 times more in dividends
4 than it anticipated earning in Net Income. Put another way, FairPoint
5 management was projecting that it would book \$890 million less in profits
6 than it would pay out to stockholders in dividends.
- 7 • During this same period, FairPoint management projected that it would only
8 reinvest 63% of its Depreciation and Amortization cash flows; D&A was
9 projected to be \$843 million – or roughly \$100 million per year -- greater than
10 capital expenditures. I would note that the 2008 CapEx estimates are more
11 than double subsequent years, and include one-time outlays for DSL
12 expansion and for the back office and network systems that FairPoint must
13 create if it is to operate the businesses it proposes to acquire.

14 **Schedule RB-13: Lehman Brothers / Morgan Stanley Analysis of FairPoint's Cash**
15 **Flow Prospects Absent the Verizon Northern New England Transaction**

16 Schedule RB-13 extracts data from another highly unusual set of projections that
17 FairPoint first disclosed in a July 2, 2007 amendment to its SEC Form S-4. The
18 projections were jointly produced by two other FairPoint financial advisors (Lehman
19 Brothers and Morgan Stanley). They were presented to FairPoint’s Board of Directors on
20 January 10, 2007 and January 14, 2007 and are referred to as Annex C-1 and C-2 in the
21 July 2 filing (as well as in the July 19 Proxy/Prospectus).

22 Both Annexes were styled as “discussion materials,” and Annex C-2 (January 14)
23 is clearly an update of the much more extensive Annex C-1 (January 10). Until it was

1 filed with the SEC, the very existence – much less a copy -- of Annex C-1 had not been
 2 disclosed by FairPoint to the parties in this proceeding. A heavily redacted copy of
 3 Annex C-2 had been disclosed previously.²⁵ The redactions mostly involved projections
 4 for two scenarios called “Falcon Acquisition Case” and “Falcon Status Quo.” “Falcon”
 5 was the code name for FairPoint, and both of these scenarios clearly contemplate
 6 FairPoint’s future *without* the Verizon Northern New England transaction.

7 Schedule RB-13 reproduces the final set of “Falcon” scenarios from the January
 8 14 document (C-2).

9 Both the “Acquisition” and “Status Quo” cases contain projections from 2008
 10 through 2015 for four categories: Free Cash Flow (FCF) Before Dividends (\$ millions),
 11 FCF/Share, Dividend Payout Ratio, and Leverage. Both scenarios show a company with
 12 a worsening financial condition (at least as measured by these four metrics), with
 13 declining free cash flows and rising dividend payout and leverage ratios. The Status Quo
 14 case produces what I would describe as an untenable situation for FairPoint, but the
 15 Acquisition case is not that much better.

16 To demonstrate this point, I will focus on one metric for the two scenarios:
 17 Dividend Payout Ratio (the proportion that dividends represent of Free Cash Flow before
 18 dividends):

Projected Dividend Payout Ratios

	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>
<i>Falcon Acquisition Case</i>	92%	93%	97%	98%	101%	118%	125%	150%
<i>Falcon Status Quo</i>	97%	106%	120%	132%	150%	172%	202%	256%

²⁵ DPS 1-69.3 in Vermont

1 Unless it is willing (and permitted) to dip into savings or borrow money to pay
2 dividends, a firm obviously cannot pay out more than 100% of its free cash flows. Under
3 the Status Quo scenario, FairPoint’s payout ratio would be 106% in 2008.²⁶ Under this
4 truly unreal scenario, the company would be paying \$2.56 for every \$1.00 of free cash
5 flow by 2015.

6 The Acquisition Case scenario presumably assumes some level of acquisition
7 activity in the future; it has slightly higher initial free cash flows, which decline much
8 less precipitously than the Status Quo scenario. However, FairPoint’s payout ratio still
9 tops 100% in 2012 and rises to 150% by 2015. Even with continued – if more modest –
10 acquisition activity, FairPoint’s financial advisors’ projections do not paint a picture of a
11 sustainable business model.²⁷

12 Based on FairPoint’s financial advisors’ own analysis, I conclude that FairPoint
13 management and its Board of Directors believed that they had little alternative to
14 pursuing the Verizon Northern New England acquisition, whatever the risks.

15 FairPoint has scoffed at my previous suggestion (in my Vermont public testimony
16 and repeated here) that this transaction could be viewed as “a bit of a ‘hail Mary.’” It
17 also objected vigorously to similar observations made by an analyst at Morgan Stanley
18 Research, who wrote in early June:

19 “We are concerned that FairPoint’s apparent expectation that it will not be
20 able to generate enough cash to pay its current dividend without the
21 proposed merger with Verizon’s NH, ME, and VT lines suggests that the

²⁶ FairPoint reported that its 2005 payout ratio was 87%.

²⁷ Annex C-1 (the January 10, 2007 Lehman Brothers / Morgan Stanley “discussion materials” document) also contains Acquisition and Status Quo case projections. These are more pessimistic than the revised projections reflected in the January 14 update (C-2). For example, the Acquisition Case scenario begins with a slightly lower payout ratio in 2008 (90%), but rises more rapidly to 106% in 2012 and to 160% in 2015. The Status Quo case projections start at a payout ratio of 103% in 2008 and rise to 331% in 2015.

1 company is in a vulnerable position. . . .[W]e are concerned that FairPoint
2 may be in a position where the Verizon NE lines transaction has become a
3 necessity . . . rather than an option.”²⁸

4 ***B. FairPoint’s Financial Capability***

5 **Q. You have summarized your overall opinion of FairPoint’s financial capability.**

6 **Please explain in detail how you reached this opinion.**

7 A. I evaluated public and confidential data, separately, to test not only whether FairPoint
8 could consummate the transaction, but also what the structure of the transaction indicated
9 about FairPoint’s financial capability. In addition, I evaluated FairPoint’s “margin of
10 error” in this transaction and the nature of any “cushions” it might have available to it to
11 recover from negative variations from its plan. I also evaluated FairPoint’s historic
12 performance and its business model.

13 **Q. What do you conclude about FairPoint’s financial capability to undertake this**
14 **transaction and to operate the Verizon New Hampshire system in a reliable**
15 **manner?**

16 A. The nature of this transaction, combined with FairPoint’s history and structure, raise
17 serious questions about FairPoint’s ability to successfully execute this transaction and
18 implement the myriad of fault-intolerant processes that it requires. Fundamental to
19 FairPoint’s plan is the assumption that it can simultaneously replace some 600 Verizon
20 systems and squeeze some 8% to 10% out of NNE’s operating expenses, all within a very
21 short time-frame. I conclude that FairPoint has an extremely small margin of error. If it
22 fails by even a modest margin to execute its plans, FairPoint will be subject to financial
23 pressures that it may well not be able to withstand without taking actions that could have

²⁸ Morgan Stanley Research, “FairPoint Communications, Lowering 2008 Estimates on New Company Forecasts,”
June 5, 2007, p. 4.

1 a negative impact on employees, customers, communities, and shareholders. The
2 ramifications of such actions could, in turn, have a detrimental impact on FairPoint’s
3 operating and financial capabilities. As I discuss below, these risks are magnified by
4 several factors, including FairPoint’s relatively small size compared to the NNE
5 businesses it proposes to acquire, the significant differences between FairPoint’s existing
6 business and the NNE operations, the transformation to FairPoint that this transaction
7 will effect, and the nature of FairPoint’s business model.

8 **Q. You mentioned that FairPoint’s plans include replacing some 600 existing Verizon**
9 **systems. Without disclosing any allegedly confidential information, please explain**
10 **how this informs your conclusion that FairPoint would lack the financial capability**
11 **to reliably operate Verizon New Hampshire.**

12 A. FairPoint’s projections do not take into consideration such potential risks (copiously
13 documented in FairPoint’s multiple S-4 filings with the Securities and Exchange
14 Commission) as the negative impact of delays in closing the transaction, a longer-than-
15 anticipated transition period (during which FairPoint will be required to pay Verizon
16 substantial amounts for “back office” and other services), higher-than-anticipated costs
17 associated with the replacing the 600 Verizon systems, less-than-adequate performance
18 of the replacement systems, and many more. FairPoint’s financial projections assume
19 essentially flawless execution of the integration. If everything does not go perfectly, it
20 could cause significant financial harm to FairPoint.

21 FairPoint’s Michael Haga, in his Pre-Filed Direct Testimony, pointed out the
22 differences between previous transactions that FairPoint has executed and the proposed
23 NNE deal: “[T]here are aspects of this acquisition that obviously make this transition

1 different from others we have done, namely the size of the transaction, the need to
2 migrate from existing Verizon systems, and the addition of a wholesale business serving
3 CLECs and other wholesale customers.”²⁹

4 Mr. Haga, who is charged with a range of transition planning and cutover-related
5 tasks, disclosed that the tasks that FairPoint must confront are larger and more complex
6 than they first appeared to me to be. He indicated that the services that Verizon will
7 provide under the TSA “only provides for services in support of regulated LEC activities.
8 Services for unregulated or non-LEC activities including long distance, Internet service,
9 and customer premises equipment sales must be provided, at closing, by FairPoint.” In
10 addition, he states that “Verizon is not providing some services that would be used by the
11 LEC. Most notably among these are procurement and logistics for materials and supplies
12 and sales operations systems used by the sales force calling on customers.” He indicated
13 that Capgemini will be responsible for building those systems as well.³⁰

14 Once again, FairPoint’s financial model assumes perfect execution of these
15 incredibly complex tasks.

16 **Q. You mentioned that FairPoint’s historic business is significantly different from that**
17 **of NNE. Without disclosing any allegedly confidential information, please**
18 **elaborate.**

19 A. The NNE and FairPoint businesses are rural, to be sure, but their business models are
20 very different. Beyond the obvious difference in size (and FairPoint’s need to focus on
21 widely scattered and extremely small subsidiaries), all of FairPoint’s subsidiaries are

²⁹ Michael Haga, p. 4

³⁰ Id., p. 11.

1 “rate of return” carriers and receive 6% to 7% of their revenues from the Universal
2 Service Fund. These are very different businesses than the vastly larger and integrated
3 NNE operations. Moreover, it is neither reasonable nor useful to compare FairPoint’s
4 “broadband” penetration by its subsidized subsidiaries with Verizon’s current level of
5 deployment. Also, expectations for FairPoint’s success in increasing NNE’s deployment
6 based on FairPoint’s past experience may well be misplaced. FairPoint enjoys both
7 operating subsidies and a guaranteed rate of return in its rural operating companies and
8 Verizon does not.

9 **Q. In his direct testimony, Labor witness Dr. Peres discusses the need for FairPoint to**
10 **make a strong commitment to improving Verizon’s substandard service. From your**
11 **review of FairPoint’s financial projections, is FairPoint making such a**
12 **commitment?**

13 A. No, FairPoint’s financial projections do not show a strong commitment to improving
14 service quality. For example, FairPoint’s projected capital budget for the years 2008
15 through 2015 shows that FairPoint is budgeting 25 times more in capital spending for
16 growth than it is for service improvement. In fact, FairPoint’s capital budget shows
17 spending on service improvement would constitute only about 2% of its capital spending
18 in each year.

19 **Q. In your opinion, do FairPoint’s capital spending priorities show a strong**
20 **commitment to improving service quality?**

21 A. No, FairPoint is focused on spending money to improve its profitability and try to stem
22 the decline in line losses. FairPoint’s proposed capital budget shows that it will be
23 making just minimal investments to improve service quality to existing customers.

1 *C. FairPoint's Focus on Dividends and Cash Flows*

2 **Q. You mentioned earlier that FairPoint's business model is based on paying a very**
3 **high dividend, and the company's focus is on generating sufficient cash flows to**
4 **sustain that dividend. How do you know this?**

5 A. FairPoint and its advisors are very clear about the importance of cash flows and the
6 purported benefits (to FairPoint) of the proposed transaction in furtherance of its
7 acquisition strategies.

8 The testimony of FairPoint's two financial witnesses is replete with discussions of
9 the importance of cash flows.³¹ For example, FairPoint Executive Vice-President Walter
10 Leach states: "Critical to the commitment FairPoint is making is the ability to generate
11 cash flow in excess of amounts required to support the planned investment operations and
12 other obligations."³²

13 FairPoint expert witness Michael J. Balhoff, in response to a question about how
14 policymakers should review this transaction from a financial point of view was clear: "In
15 terms of the financial perspective, policymakers should consider whether FairPoint has
16 the ability to generate realistic cash flows to meet its pledge to increase capital
17 commitments and to fulfill its obligations to its employees."³³ He also argued that "in the
18 unlikely event that the operating environment proves more negative than the company's
19 modeling," FairPoint would have a number of options available to it. These options, he

³¹ Pre-Filed Direct Testimony of Walter E. Leach, Jr, FairPoint's Executive Vice President, Corporate Development, and of Michael J. Balhoff, Managing Partner of Balhoff & Rowe, LLC. Much of the most significant testimony of Messrs. Leach and Balhoff was filed under seal. Both of their statements were public in part and confidential in part. While I address both of these witnesses' confidential testimony in my own Confidential Statement, I rely only on the public aspects of their testimony in this statement.

³² Leach, p. 5; also see Leach at pages 36-37 ("we will be able to generate significant free cash flow"); Leach describes his job as being "responsible for all aspects of FairPoint's merger and acquisition activity as well as strategic planning." p. 2

³³ Balhoff, p. 14

1 continued, “include the opportunity to further reduce line losses, add incremental
2 revenues through new products, adjust the company’s cost structure, scale capital
3 expenditures or alter the company’s dividend policy.” The last two options, in
4 Mr. Balhoff’s words, “would only be invoked if the operations became distressed.”

5 **Q. Are you saying that FairPoint would reduce employment, increase customers’ rates,
6 or scale back plans to implement new services before it cuts its dividend?**

7 A. Yes, that is precisely what FairPoint says. I believe that it is worth noting that some sort
8 of revenue raising and cost cutting (almost certainly involving employee compensation or
9 outsourcing, or both) would be what Mr. Balhoff expects FairPoint to do first. Then, “if
10 the operations became distressed,” Mr. Balhoff lists FairPoint’s option to “scale capital
11 expenditures” (that is, reduce capital spending) and, finally, “alter the company’s
12 dividend policy.”³⁴ Note the order and priority in Mr. Balhoff’s list. From this
13 statement, and many other indications, it is clear that FairPoint management will consider
14 almost any alternative to reduce costs before turning to its high dividend policy.

15 **Q. Why is a high dividend so important to FairPoint?**

16 A. While it is obvious that a high dividend policy is designed to please shareholders, it plays
17 a key role in FairPoint’s long-range business strategy. For example, FairPoint Chairman
18 and CEO Frank Johnson told a group of investment analysts on a conference call the day
19 the transaction was announced: “And to everyone, I state clearly that these new revenue
20 opportunities and enhanced operating efficiencies will improve our financial base and
21 further enhance our acquisition platform.”³⁵ FairPoint’s proxy statement / prospectus

³⁴ Balhoff, p. 14

³⁵ FairPoint SEC Form 8-K, January 19, 2007

1 makes a similar point: "The merger would improve the combined company's acquisition
2 platform which should allow it to generate even more synergies from follow-on
3 acquisitions."³⁶ FairPoint's Mr. Leach echoes: "FairPoint is and will continue to be a
4 telephone acquisition and operating company. ... After we have completed the merger
5 and successfully converted all systems and processes to the FairPoint platform, and are
6 assured our customer service operations are at acceptable levels, we will then consider
7 future acquisitions, because increasing scale and scope is important to continuing to
8 provide efficient services to our customers."³⁷

9 FairPoint's plan to continue being an acquisition company is important.
10 FairPoint's high dividend pumps up its stock price and makes that stock valuable
11 "currency" for future acquisitions. If FairPoint were not so intent on being an
12 acquisitions company, it would be less important for it to maintain such an
13 extraordinarily high level of dividend payments.

14 **Q. How does all of this relate to FairPoint's ability to generate cash flows and how**
15 **FairPoint uses that cash?**

16 A. FairPoint is preoccupied with generating cash flows to enable it to pay its very high
17 dividends and pursue acquisitions. As I explain elsewhere, FairPoint relies heavily on
18 depreciation to sustain these cash flows, with capital expenditures averaging about one-
19 third less than the depreciation-derived cash flow that FairPoint realized. I am very
20 concerned that a financially-driven firm like FairPoint will not have the interests of
21 NNE's constituents at heart, particularly when the chips are down.

³⁶ Proxy/Prospectus, July 19, 2007, p. 65

³⁷ Leach, pp. 42-443

1 **Q. Why is it important that FairPoint spends less on capital expenditures than it**
2 **collects in depreciation?**

3 A. Depreciation is an accounting convention designed to recognize that capital assets wear
4 out over time and provide companies with the resources to replace worn out or obsolete
5 capital. Depreciation is designed to provide a source of funds for a company to replenish
6 or upgrade its fixed plant. Instead of using depreciation for this purpose, FairPoint only
7 reinvests in its networks about two-thirds of the amount it recovers in depreciation. It
8 uses the rest to pay dividends to stockholders.

9 Simply, FairPoint is disinvesting in its network. Every year, the amount of net
10 plant on FairPoint's books (value of plant less accumulated depreciation) declines. In
11 regulatory parlance, FairPoint's rate base is shrinking because it is not reinvesting in its
12 network. Instead, it uses the cash it should be investing and pays it out in dividends.

13 *D. FairPoint's Size and Level of Experience*

14 **Q. You have mentioned your concerns with FairPoint's size and level of experience. Is**
15 **there anything in FairPoint's history that approaches an operation of the size and**
16 **scope of the NNE operations?**

17 A. No, there is not. The closest that FairPoint came to an operation of this size was its entry
18 into the CLEC business in 1998, via a subsidiary called FairPoint Solutions. Three years
19 later, when FairPoint decided to discontinue its CLEC operations, it had accumulated
20 several hundred million dollars in losses, laid-off at least 365 employees, "notified its
21 remaining customers in the Southwest, Southeast, and Mid-Atlantic competitive markets
22 to find alternative carriers," and came perilously close to bankruptcy. In the end, it was
23 able to negotiate an exchange of Solutions' debt for about \$100 million in redeemable

1 preferred shares, as well as incur substantial additional charges as it wound down this
2 subsidiary.

3 FairPoint attempts to explain its failed CLEC venture by stating that it was “an
4 experiment in a new market... that proved to be ill-timed.”³⁸ This is probably true.
5 However, this was also the only time that FairPoint has attempted to develop a business
6 on such a large scale. I believe that FairPoint’s failed CLEC endeavor was larger than any
7 single FairPoint ILEC operation at the time, and probably larger than any single FairPoint
8 ILEC today. Moreover, the CLEC business was a separate reportable segment,
9 accounting for about 20 percent of FairPoint’s revenues in 2000 (\$54 million of \$246
10 million in FairPoint revenues) and more than half of its capital expenditures in that year
11 \$57.5 million of FairPoint’s \$107.8 million in such expenditures). More to the point,
12 whatever size the CLEC operation was, it exposed FairPoint to huge risks – and
13 ultimately caused FairPoint debentures to go into default and cost FairPoint over \$200
14 million. FairPoint made an enormous bet on a large-scale operation, losing hundreds of
15 millions of dollars, and wiping out the company’s net worth, and then some. Largely as a
16 result of this failed venture, FairPoint’s shareholder equity went from \$64.4 million in
17 2000 to a negative \$149.5 million in 2001, a negative swing of \$213.9 million³⁹. The
18 failed CLEC venture, in retrospect, seems to have dramatically undermined FairPoint’s
19 earlier growth trajectory (see Schedule RB-10).

20 The simple truth is that FairPoint’s management was not able to manage the scope
21 and complexity of the operation. Yet, this is FairPoint’s only experience with any

³⁸ Federal Communications Commission, WC Docket No. 07-22, Opposition to Petitions to Deny, Submitted by attorneys for Verizon and FairPoint, May 7, 2007 (Opposition to Petitions).

³⁹ FairPoint SEC Forms 10K, 2000, 2001 and 2002.

1 business venture that even begins to approach the size and complexity of the proposed
2 transaction, and it failed miserably. Moreover, five of FairPoint’s key officers – Eugene
3 B. Johnson, Walter E. Leach, Jr., Shirley J. Linn, Lisa R. Hood, and Peter G. Nixon –
4 held significant positions at FairPoint during at least part of this financial debacle.

5 *E. The Risks of Verizon Divestitures*

6 **Q. You have described in some detail the risks of the proposed transaction. Are these**
7 **risks purely hypothetical?**

8 A. No, these risks are very real. In 2005, Verizon engaged in a very similar transaction in
9 Hawaii. It sold its 715,000 access lines in Hawaii to the Carlyle Group, a large private
10 equity firm, for \$1.65 billion. Verizon and the Carlyle Group made many of the same
11 claims as Verizon and FairPoint are making in this sale. Unfortunately, many of the
12 concerns I am raising about FairPoint came to pass with the new owner.

13 Carlyle Group created a subsidiary called Hawaiian Telcom to become the local
14 telephone company. Hawaiian Telcom entered into a Transition Services Agreement
15 (TSA) with Verizon for the continuation of certain Verizon functions for up to nine
16 months after the closing of the sale “to provide Hawaiian Telcom with adequate time to
17 establish new and independent back office support systems in the State. Additionally,
18 Carlyle engaged the services of BearingPoint, Inc. to establish the new and independent
19 back office support systems.”⁴⁰ This deal is nearly identical in concept to FairPoint’s
20 proposed TSA with Verizon and CapGemini.

⁴⁰ Docket 04-0140, In the Matter of the Application of Paradise Mergersub, Ind., GTE Corporation, Verizon Hawaii Inc. Bell Atlantic Communications Inc. and Verizon Select Services, Inc. for Approval of a Merger Transaction and Related Matters, Decision and Order No. 21696 filed, March 16, 2005 pp. 19 and 20.

1 Unfortunately, Hawaiian Telcom experienced significant problems despite the
2 TSA. In a November 2006 report, Moody’s Investor Service reported that Hawaiian
3 Telcom had not managed to develop the systems it needs to function as a stand-alone
4 business, citing a “continuing delay in creating fully functioning back office systems [that
5 in turn] is contributing to numerous operational problems (i.e., customer care, order
6 management, billing, and financial reporting) and distracting senior management.”⁴¹
7 Moody’s downgraded Hawaiian Telcom’s speculative grade liquidity from SGL-3 to
8 SGL-4 meaning liquidity is so weak that the company must rely on external financing
9 services stating “[t]he company’s financial and operating profile could be permanently
10 impaired if the systems issues are not resolved quickly.” Standard and Poor’s followed
11 suit in March 2007 when it cut Hawaiian Telcom’s rating one level to B-. Standard and
12 Poor’s stated that Hawaiian Telcom has a “highly leveraged financial profile” whose
13 “profitability significantly lags its peers.”⁴²

14 Hawaiian Telcom also had significant problems with new billing systems. The
15 company established a new \$100 million operations system to handle the functions that
16 previously were conducted by Verizon. The company also hired an additional 120
17 workers but the problems still persisted. Ultimately, Hawaiian Telco replaced its IT and
18 related services consultant, BearingPoint, with Accenture.

19 The experience of Hawaiian Telcom and the TSA should act as a cautionary tale
20 for regulators examining the proposed Verizon-FairPoint transaction. There are
21 important similarities between the two transactions. In both transactions, Verizon sells its

⁴¹ The Deal, Carlyle continues to stumble with Hawaiian Telecom acquisition: Carlyle’s Hawaiian Disconnect, December 4, 2006.

⁴² Bloomberg News Service, Standard and Poor’s cuts Hawaiian Telcom to B- rating, March 30, 2007.

1 local exchange operations to a highly leveraged firm that lacks experience with an
2 operation of this magnitude; the purchasers need to develop and integrate new operating
3 and support systems; and each of the purchasers enter into a TSA with Verizon to
4 ostensibly smooth the transition process. However, one difference between the two
5 situations is that the Carlyle Group has major financial resources it can extend to
6 Hawaiian Telcom if it so desires. FairPoint will not have access to such resources.

7 **Q. Is that the only Verizon divestiture of a local telephone business?**

8 A. No, it is not. I am also aware that in 2002, Verizon sold its local operations in Kentucky
9 to Alltel (approximately 600,000 lines), and its local operations in Alabama and Missouri
10 to CenturyTel (approximately 300,000 and 370,000 lines, respectively). From what I
11 have read about those transactions, and what I have heard from people at CWA familiar
12 with the transactions, those divestitures did not result in serious operational problems.

13 This highlights the importance of selling to an experienced telecommunications
14 company that has the existing size, systems, and expertise to manage an operation of this
15 size. The deal with Alltel represented about a 25% increase in Alltel's access lines. The
16 deal with CenturyTel represented an increase of closer to 40% in that company's number
17 of access lines. Alltel and CenturyTel were largely able to integrate Verizon's operations
18 into existing systems and operations centers. While there are always transitional tasks
19 (such as transferring customer records), when a telephone company is transferred to an
20 experienced company's existing systems, that transaction can occur smoothly.

21 That will not be the case here. The proposed deal with FairPoint is so large
22 (representing almost a 600% increase in FairPoint's size), and so unlike anything that
23 FairPoint has done in the past, that FairPoint cannot integrate NNE into existing FairPoint

1 systems. Instead, FairPoint has to develop dozens of complex systems and operations
2 from scratch in order to attempt to run the NNE operations.

3 *F. Evaluating FairPoint's Execution Risk*

4 **Q. You have said that there were serious risks that FairPoint would not be able to**
5 **execute this transaction. Please elaborate.**

6 A. Based on both this testimony, and certain confidential information that I have evaluated
7 in the context of this proceeding, it is clear that there are a number of entirely credible
8 scenarios that would result in a financial crisis for FairPoint. Such a crisis would require
9 FairPoint to make some very hard decisions, each of which could have its own negative
10 ramifications. They would all revolve around insufficient cash to fund all of the promises
11 that FairPoint has made to its customers, employees, communities, regulators,
12 shareholders, and lenders.

13 One public example that I can mention is the recent decision by a Hearing
14 Examiner in Maine determining that Verizon had overcharged its customers by \$32.4
15 million in 2004. While that proceeding is still under way, and I obviously cannot know
16 the ultimate outcome, a loss of income of this order of magnitude – presumably on an
17 annual basis – could be a body-blow to FairPoint's projections. The \$32.4 million
18 represents over 21% of Spinco/NNE's pro forma adjusted 2006 operating income (29%
19 before pro forma adjustments and 16% of the combined entities' 2006 pro forma adjusted
20 2006 operating income). While this loss in revenue, were it to occur, would likely be
21 somewhat mitigated by a reduction in taxes (to the extent that FairPoint would actually be
22 paying a material amount in cash taxes), much of it would flow to the FairPoint bottom
23 line. This would significantly reduce FairPoint's free cash flow.

1 Similarly, if FairPoint is not able to reduce NNE’s operating expenses by what
2 has been variously represented as 8% to 10% or \$60 to \$75 million, it would be forced to
3 make the very difficult decisions I have mentioned elsewhere. Moreover, FairPoint
4 would need to sustain these cost savings indefinitely into the future. It certainly couldn’t
5 permit NNE’s unit operating expense growth to return to the 5-8% annual growth rate
6 experienced historically by both Verizon NNE and FairPoint.

7 While FairPoint’s “pro forma” projections for reducing Spinco operating expense
8 – virtually overnight – may work mathematically, I am quite skeptical about FairPoint’s
9 ability to realize these hypothetical savings in the real world.

10 FairPoint’s “cost reduction” mantra flies directly in the face of historic per access
11 line operating expense growth trends for both NNE and FairPoint. A significant “miss”
12 with either the up-front cost savings or continuing cost reductions (or both) would also
13 force FairPoint to make the difficult decisions I have described elsewhere. NNE’s 2006
14 operating expenses were around \$1 billion, while its unit costs (per access line operating
15 expenses) grew by 7.1%. Assuming this trend holds, FairPoint \$60 to \$75 million in
16 synergies will already be significantly below the 8% to 10% that FairPoint has
17 mentioned.

18 Indeed, when the transaction was originally announced, FairPoint said that its
19 synergy savings would be achieved, in the words of FairPoint Executive Vice President
20 and Chief Financial Officer John Crowley, by eliminating “\$60 million to \$75 million in
21 expected synergies and cost savings or approximately eight to ten percent of current

1 operating expense.”⁴³ According to Crowley, these savings will come primarily from
2 about \$240 million in allocations for “support and back-office operations” provided to
3 NNE by Verizon. These numbers were based on Verizon’s 2005 results, but, just a few
4 months later, FairPoint’s SEC Form S-4 disclosed that these back-office charges had
5 grown to \$270 million, a 12.5% increase.

6 None of this, by the way, takes into account the fate of the existing FairPoint
7 business, which, as I have discussed elsewhere, seems to have hit a plateau following the
8 CLEC debacle, and recently has produced little if any organic revenue growth, while
9 continuing to experience in excess of 5% growth in unit operating expenses (8% over the
10 most recent twelve months, excluding merger-related expenses).

11 **Q. Can you describe a credible “worst case” scenario, from a financial perspective.**

12 A. Actually, I’ll start with a “worst case” scenario described by FairPoint’s Executive Vice-
13 President, Walter Leach. In response to a question posed by the Labor Intervenors
14 regarding any sensitivity analyses that FairPoint or its advisors may have performed to
15 test the likelihood and impact of over- or under-achieving FairPoint’s projected cost
16 savings, Mr. Leach pointed to a confidential analysis produced by Lehman Bros. “which
17 illustrates a worst case scenario and the resulting financial metrics if \$67 million less cash
18 flow occurred.” While Mr. Leach doesn’t specify which year the \$67 million
19 underperformance applied, it appears that this “worst case” number represents the point
20 at which FairPoint’s Board of Directors would abandon the transaction.⁴⁴

⁴³ FairPoint SEC Form 8K, February 23, 2007; February 21, 2007 transcript of the 4th Quarter 2006 Earnings Conference Call

⁴⁴ FairPoint: CFPNH0044

1 **Q. It seems that much of the risk you discuss is based on FairPoint’s projected**
2 **reductions in Verizon NNE’s operating costs. Can you explain how FairPoint has**
3 **developed its cost-savings estimate?**

4 A. FairPoint recently provided a spreadsheet that contains details of its projected synergies
5 savings.⁴⁵ This spreadsheet, which I refer to as the Synergy Model, contains the same
6 summary data as was previously provided in another confidential FairPoint document⁴⁶.

7 While I cannot publicly describe the detail contained in these documents, I can
8 observe that FairPoint argues that it will not be required to pay the costs that Verizon
9 currently allocates to its NNE operations for back office and network systems and
10 operations. And while FairPoint has contracted with CapGemini to replace these some
11 600 systems, the company argues that it will be able to successfully replicate all of
12 Verizon’s systems and operations, while saving \$60-\$75 million in the process.

13 For more detail, I will rely on a response by FairPoint’s Walter Leach to a
14 Vermont DPS information request. In his reply, Mr. Leach provided several
15 clarifications and updates regarding FairPoint’s projected “synergies” and cost savings.⁴⁷
16 According to Mr. Leach’s response, Verizon’s allocations to NNE (excluding
17 depreciation) were \$241 million in 2005 and \$262 million in 2006, fairly minor variances
18 from previously reported numbers. However, he then states that “FairPoint forecasts the
19 allocation amount to be approximately \$222 million in 2007,” a \$40 million projected
20 decline in 2007 over 2006 (while Verizon is still in control of NNE).

⁴⁵ FairPoint: Maine OPA I-3-1, provided in late June; provided in New Hampshire subsequent to July 12 meeting/teleconference to discuss the FairPoint “Discovery Model.”

⁴⁶ FairPoint: CFPNH0001-0019

⁴⁷ FairPoint: Vermont public reply; A.DPS:FP.1-78

1 Continuing, Mr. Leach said that synergies are “essentially the difference between
2 the allocated costs that go away upon the close and the incremental direct cost that
3 FairPoint must incur post-close” Using the \$222 million allocation as a starting point,
4 Leach states that “we anticipate eliminating approximately \$100 million of the \$222
5 million allocated costs.” This represents a 45% reduction from Verizon’s projected 2007
6 allocations (which are already fifteen percent lower than 2006 levels).⁴⁸

7 Mr. Leach noted that there are partially offsetting expenses to these savings in
8 areas “such as Engineering & Operations and Finance & Accounting where we
9 anticipate, among other things, additional personnel needs to replace the centralized
10 functions that will no longer continue.” He stated that these cost increases “are expected
11 to total approximately \$45 million.” This means that the initial synergies and cost
12 savings are approximately \$55 million (\$100 million reduction in Verizon NNE’s costs,
13 offset by a \$45 million increase in FairPoint’s costs). Nonetheless, Mr. Leach reasserts
14 FairPoint’s publicly projected cost savings, stating: “[T]he net of the eliminated costs
15 and increased direct costs is expected to be approximately \$60 to \$75 million on a run-
16 rate basis following the successful integration.” Thus, FairPoint appears to be projecting
17 that, after it implements its initial “synergies” and cost savings, it will continue to *reduce*
18 operating costs. This certainly runs counter to the operating expense experience of both
19 NNE and FairPoint during most of this decade.⁴⁹

⁴⁸ Mr. Leach says that among the costs that “go away” are software depreciation. He doesn’t explain why there is still depreciation in the Verizon allocation number when he also stated that the figures he provided exclude depreciation.

⁴⁹ FairPoint: Vermont A.DPS:FP.1-78

1 **Q. As the deal is presently structured, who would bear the risk of FairPoint's inability**
2 **to live up to its promises?**

3 A. As I mentioned previously, if FairPoint's projections prove to be overly optimistic and its
4 results materially suffer, it will be confronted with the need to adjust its cash flow by
5 squeezing its employees' compensation, raising prices, permitting service to deteriorate,
6 reducing investment, cutting dividends, or, more likely, a combination of these or other
7 actions. The impact of such actions is likely to severely affect New Hampshire's
8 consumers, work force, and economy.

9 For example, FairPoint might determine that it can resolve its cash flow problems
10 by raising prices, permitting service to deteriorate, and reducing capital expenditures. In
11 this case, its customers would bear the brunt (along with employees and communities,
12 depending on the secondary impacts of such actions).

13 On the other hand, FairPoint could attempt to negotiate or impose lower
14 compensation levels on its workforce, lay off employees, or outsource work to a lower-
15 cost third party. In this case, employees would obviously bear the brunt (as would
16 communities and the state to the extent that employees have lower incomes).

17 Another alternative scenario would be that FairPoint would decide to lower or
18 eliminate its dividend (or, more likely, be forced to by its lenders). Absent any other
19 actions to improve cash flow (very unlikely by that point, in my opinion), FairPoint's
20 shareholders would bear the brunt, both through the loss of dividend income and through
21 the almost certain decline in FairPoint's share price. Since FairPoint's ability to raise
22 additional capital would likely be harmed, this would also likely produce negative effects
23 for other constituencies. If it hadn't already attempted to raise prices, and reduce service

1 levels, compensation costs, and capital expenditures, it would certainly be pressured to do
2 so by its shareholders and lenders.

3 All of these examples identify potential risks to various FairPoint constituencies.
4 It is likely, though, that some constituencies would be more severely impacted than
5 others. It is my opinion that, if this transaction proceeds, the risks of the deal will be
6 allocated, in declining order, to employees, customers, communities and the state,
7 shareholders, and lenders. Based on my experience with employers and industries in
8 distress, it is almost invariable that employees feel the brunt of an employer crisis first,
9 thus they bear the highest risk if this transaction proceeds. Employees' risk from this
10 transaction would be followed by consumers of the employer's goods or services. This
11 would be particularly true in this case since consumers, particularly in rural areas, have
12 few practical alternatives. To the extent that there are layoffs, wage cuts or similar
13 actions that reduce employees' buying power, the communities in which they live will
14 likely feel the greatest impact, while (because of their greater size and more diversified
15 economies) states will feel the brunt to a lesser degree. Shareholders may well suffer
16 financial losses, but their financial and emotional pain is likely to be much smaller in
17 comparison to that of those who are more directly affected by an employer crisis. While
18 lenders bear some risk, in this transaction they appear to be well collateralized; certainly
19 more than any other group that would be exposed to risk as an result of this transaction.

1 **VI. What's in it for FairPoint**

2 **Q. Given all of the risks you identified, and FairPoint's lack of experience with**
3 **anything approaching this size of operation, do you have an opinion as to why**
4 **FairPoint would undertake this transaction?**

5 A. Obviously, I can't speak for FairPoint, but I believe that its business model has stalled
6 over the past half dozen years, as I've mentioned above and as is reflected in Schedule
7 RB-10. Just looking at the numbers, it is pretty clear that FairPoint hasn't really
8 recovered from the CLEC debacle. For an acquisition-driven company, it hadn't engaged
9 in transactions that materially increased its size and scope since 2000.

10 As I mentioned earlier in my testimony, I believe that one could view the NNE
11 acquisition as a bit of a "hail Mary." Certainly, the recently disclosed Acquisition Case
12 and Status Quo scenarios presented to FairPoint's Board by Lehman Brothers and
13 Morgan Stanley strongly reinforce this impression. The company appeared to be facing a
14 huge challenge to its business model, at the very least. The NNE acquisition provides a
15 way to "solve" this looming crisis (or, more accurately, to postpone it for a few years), if
16 only FairPoint could pull it off.

17 The deep concern that I have is that, confronted with a looming potential crisis,
18 FairPoint's Board of Directors and management were far less motivated to avoid the
19 fundamental risks inherent in this transaction than I believe they should have been.

20 Of course, FairPoint has been abetted by Verizon, which needed a willing partner
21 who had the very special attribute of being small. Verizon needed FairPoint to do this
22 deal, and judging by the \$40 million in pre-closing support and \$55 million from the
23 purchase of FairPoint's interest in the cellular partnership, Verizon was willing to go a

1 good distance to get this deal done. Ultimately, this transaction could transform
2 FairPoint or it could severely, even fatally, wound the firm. As I have pointed out in this
3 Statement, there are large degrees of risk for everyone, and FairPoint and its shareholders
4 are no exception.

5 **VII. Recommended Commission Action**

6 **Q. Based on your entire analysis of the proposed transaction, including your allegedly**
7 **confidential analysis described in Labor Intervenors Statement 3 and Dr. Peres's**
8 **testimony about service quality (Labor Intervenors Statement 1), what do you**
9 **recommend?**

10 A. I recommend without reservation that the PUC decline to approve this proposed
11 transaction. In the process, I strongly urge the PUC to set forth benchmarks for Verizon
12 to follow if it indeed remains determined to divest itself of its Northern New England
13 businesses.

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

1 **Q. Can't the risks you have identified be reallocated to FairPoint through the use of**
2 **various conditions in a Commission order?**

3 A. No, I don't think so. While there are many cases where a transaction's risks can be
4 ameliorated or reallocated through regulatory conditions, I do not believe this to be
5 feasible here. FairPoint is simply not in a position to agree to a regulatory regime that
6 would more fairly allocate the risks to all constituents. FairPoint does not have the
7 resources to share the risks and rewards more equitably. Moreover, such a structure
8 would run directly counter to FairPoint's business model of acquiring firms for their cash
9 flows – relying heavily on depreciation – to maintain very high dividend levels that will
10 facilitate the next acquisition.

11 For example, I am advised by counsel that one type of condition that is often
12 imposed by regulators is a restriction on the proportion of net income that can be paid to
13 the parent as a dividend (for example, limiting the dividend to 75% of net income). If
14 such a reasonable restriction were imposed on the NNE operations, it would completely
15 undercut FairPoint's business plan – forcing FairPoint to drastically reduce its dividend,
16 slash its capital spending, or take extreme actions to reduce its work force or increase
17 consumers' rates.

18 In order for FairPoint to meet its promises, it requires not only perfect execution
19 of the transition, but also the ability to pay dividends that are three or four times as large
20 as its net income. FairPoint simply could not function if a reasonable restriction were
21 imposed on the dividend payments from NNE to the parent company.

1 **Q. If the Commission disagrees with you and determines that the proposed transaction**
2 **should be approved with conditions, are there financial conditions that might help**
3 **to protect the interests of consumers and workers in New Hampshire?**

4 A. As I said, I do not believe that conditions can fully protect the interests of Verizon's
5 customers and employees in New Hampshire. I believe the public would be better served
6 by the Commission rejecting the transaction, rather than approving it and having to deal
7 with the consequences posed by FairPoint's lack of experience and precarious financial
8 condition.

9 If the Commission disagrees with me, however, and decides to approve the
10 transaction, that approval must be conditioned in a way that at least tries to avoid (or at
11 least minimize the adverse impacts from) serious financial problems for local telephone
12 operations in New Hampshire. Specifically, I recommend the following conditions
13 related to FairPoint's financial condition:

- 14 1. NNE will be prohibited from paying dividends to FairPoint Communications
15 Inc. (or any other affiliate thereof) (collectively "FairPoint Parent") or from
16 otherwise transferring cash to FairPoint Parent through loans, advances,
17 investments or other means that would divert NNE's moneys, property or
18 other resources that is not essentially or directly connected with the provision
19 of non-competitive telecommunications service if NNE fails to meet or exceed
20 the standard for a majority of the service quality measures (see the testimony
21 of Dr. Peres for the types of service quality conditions that should be
22 established for FairPoint).
- 23 2. Dividends on common stock of FairPoint's existing operations in New
24 Hampshire must be suspended if service quality at FairPoint's existing
25 operations in New Hampshire deteriorates, using the same criteria to be
26 established for NNE (as discussed by Dr. Peres).
- 27 3. The financing for the acquisition will not be secured by NNE's assets, nor
28 shall NNE or its affiliates be allowed to pledge NNE's assets.
- 29
30
31

- 1 4. NNE will not provide any financial guarantees to facilitate this, or any other
2 acquisition.
- 3
- 4 5. The amount of annual dividends NNE can distribute to FairPoint Parent is
5 further limited as follows:
 - 6
 - 7 a. The cumulative dividend NNE can declare in any year may not exceed
8 the difference between that year's earnings (income or loss) before
9 interest, taxes, depreciation, and amortization (EBITDA) and 100% of
10 its depreciation expense. This restriction will require that an amount of
11 cash, equal to 100% of that year's depreciation expense, will be
12 available for NNE's capital expenditures.
 - 13
 - 14 b. In any year that the amount of depreciation expense retained by NNE
15 is in excess of its capital expenditures, NNE shall account for such
16 funds in a subaccount of Account 1410, Other Noncurrent Assets. The
17 cumulative annual depreciation expense retained at NNE will assure
18 adequate funds are available to complete future capital expenditures,
19 as required.
 - 20
 - 21 c. In years when the total depreciation expense does not cover capital
22 expenditures, NNE may use the accumulated depreciation funds to
23 pay for this incremental amount of capital expenditures, provided that
24 NNE notifies the Commission of such a need no later than 45-days
25 prior to the use of the funds.
 - 26
 - 27 d. Suspend this dividend restriction to the extent NNE is able to maintain
28 an average daily balance in the depreciation fund subaccount of
29 Account 1410 for a calendar year of 1.0 times its average annual
30 capital expenditures for the last five calendar years. The dividend
31 restriction will become operative whenever this criterion is not
32 satisfied. Further, we will suspend the restriction if FairPoint obtains
33 an investment grade bond rating.
 - 34
- 35 6. NNE must maintain a consolidated common equity ratio of at least 40% of
36 total capitalization before any declaration of a dividend on common stock.
37 Total capitalization includes: long term debt (including current sinking fund
38 requirements), short term debt (including capital leases), minority interest, and
39 stockholders' equity. Further, no dividend payment will be permitted which
40 would cause NNE's consolidated common equity ratio to fall below 40%.
- 41
- 42 7. NNE and its subsidiaries shall be prohibited from making any loans or
43 financial advances to FairPoint.
- 44
- 45

1 **Q. In your opinion, are these conditions commercially reasonable?**

2 A. Yes, in my opinion these conditions are commercially reasonable. By that I mean that a
3 company providing local telephone service should be able to continue to operate reliably
4 and maintain its network without violating these restrictions. In my opinion, these
5 conditions would not pose an undue financial burden or hardship on a well-run,
6 appropriately capitalized telephone company.

7 **Q. To the best of your knowledge, have conditions like this been imposed in other**
8 **transactions?**

9 A. I am not a regulatory expert, but I am advised by counsel that conditions nearly identical
10 to these have been imposed on FairPoint by regulatory commissions in New York and
11 Illinois.⁵⁰ I have reviewed copies of those orders (as provided by counsel), and it appears
12 that FairPoint voluntarily agreed to conditions very similar to these in order to (a) obtain
13 approval for an acquisition of a small telephone company (New York), and (b) obtain
14 approval for a public offering of its common stock (Illinois). The fact that FairPoint has
15 agreed to very similar conditions in other jurisdictions reinforces my opinion that these
16 are commercially reasonable conditions.

17 I am also advised by counsel that other state utility commissions have imposed
18 financial conditions, including limitations on dividend payments, that are designed to
19 protect a regulated utility from adverse financial effects of unregulated or out-of-state

⁵⁰ *Joint Petition of Berkshire Telephone Corporation, FairPoint Communications, Inc., MJD Ventures, Inc. and FairPoint Berkshire Corporation for Approval of the Merger of FairPoint Berkshire Corporation with and into Berkshire Telephone Corporation*, CASE 03-C-0972, New York Public Service Commission, 2005 N.Y. PUC LEXIS 124 (March 18, 2005); *FairPoint Communications, Inc., C-R Telephone Company, The El Paso Telephone Company, Odin Telephone Exchange, Inc. and Yates City Telephone Company - Joint Application for approval of the Recapitalization of FairPoint Communications, Inc. pursuant to Sections 7-203 and 7-204 and for other relief*, Illinois Commerce Commission Docket No. 04-0299, 2004 Ill. PUC LEXIS 278 (May 26, 2004).

1 operations of a holding company. These provisions are generally known by the term
2 “ring fencing” because they, in effect, build a financial fence around the utility to protect
3 it from unregulated actions of the parent company or other affiliates.

4 **Q. In addition to these financial conditions, are there other types of conditions the**
5 **Commission should consider if it rejects your primary recommendation?**

6 A. Yes. In addition to financial conditions, the Commission should consider conditions
7 related to service quality (as discussed by Dr. Peres). The Commission also should adopt
8 conditions related to the transition of billing, network operations, and customer service
9 systems from Verizon to FairPoint. This type of condition might require an independent
10 auditor to verify the readiness of FairPoint's computer and operational systems.
11 Similarly, the Commission should consider requiring an independent audit of the
12 condition of Verizon's facilities, including an assessment of the expenditures that would
13 be necessary to bring them up to acceptable standards. The Commission then could
14 determine whether Verizon should be responsible for any or all of the cost of making
15 necessary improvements.

16 **Q. If the Commission rejects this deal, aren't there risks associated with Verizon's**
17 **continued ownership of the New Hampshire operations?**

18 A. Yes, there are also risks associated with Verizon's continued ownership of assets it no
19 longer wants, but those risks are more evenly allocated. Moreover, assuming Verizon is
20 intent on divesting itself of the Northern New England assets, a rejection of this high-risk
21 transaction will send a clear message to the company that it must create a transaction that
22 more equitably balances the risks to all of NNE's constituents.

1 **Q. Earlier, you mentioned that the Commission could establish “benchmarks” for a**
2 **Verizon divestiture of its New Hampshire operations. What do you mean by that?**

3 A. By “benchmarks” I mean that in addition to rejecting this transaction, the Commission
4 also may wish to put Verizon on notice about the types of requirements that would be
5 expected of any proposed acquirer of Verizon New Hampshire.

6 **Q. What types of benchmarks would you propose?**

7 A. I would propose that the Commission establish four broad benchmarks that must be met
8 if it is to approve any proposed acquisition of Verizon New Hampshire (as well as any
9 other Verizon businesses that might be part of a new proposed transaction). In the
10 context of any proposed transaction in its entirety, the proposed acquirer must
11 demonstrate that it has:

- 12 1. Adequate capitalization;
- 13 2. Adequate reserves;
- 14 3. Adequate infrastructure; and,
- 15 4. A demonstrated ability to absorb, integrate, and operate entities of comparable
16 size and complexity to the entities the acquirer is proposing to acquire.

17 **Q. Just to be clear, in your opinion, does FairPoint meet any of these benchmarks?**

18 A. No, it does not. FairPoint fails on every reasonable measure of a competent successor to
19 Verizon New Hampshire.

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

21 A. Yes, it does, based on the information that has been available to me as of approximately
22 July 27, 2007. If I receive additional information after that date, in New Hampshire or
23 the other states with parallel proceedings, some of my opinions and analyses may change.

Relative Contributions to the Post-Transaction New FairPoint

	FairPoint	Verizon ME-NH-VT	FRP/VZ-NNE Combined	VZ:FRP Ratios	FRP:VZ Ratios
Access Lines	14%	86%	1,779,898	6.1	0.2
Revenue (\$ in millions)	18%	82%	\$1,469	4.6	0.2
EBITDA (\$ in millions)	24%	76%	\$566	3.2	0.3
Ownership (shares, millions)	40%	60%	88.9	1.5	0.7

Source: FairPoint Communications, SEC Forms 8K, January 16, 2007, January 19, 2007

Comparative FairPoint 2006 Actual and Pro Forma Per Share Data

For the Year Ended 31-Dec-06

FairPoint Actual

Earnings per share from continuing operations	\$0.88
Book value per share	\$6.38
Cash dividends per share	\$1.59

Pro Forma Combined Company

Earnings per share from continuing operations	\$0.42
Book value per share	\$3.36
Cash dividends per share	\$1.59

Source: FairPoint SEC Form S-4

2006 Dividends as a Percent of Net Income Verizon, FairPoint, Combined FairPoint/NNE Pro Forma

Dividends	Net Income	Excess of Dividends Over Net Income	Dividends as % of Net Income
(\$millions)			%

Verizon (2006)	\$4,719.0	\$6,197.0	(\$1,478.0)	76%
FairPoint (2006)	\$55.2	\$31.1	\$24.1	177%
Combined FairPoint-NNE, Pro Forma, 2006	\$140.9	\$37.0	\$103.9	381%

Sources: Verizon and FairPoint SEC Form 10K, FairPoint SEC Form S-4

Comparative 2006 Debt-to-Equity Ratios

	Long Term Debt (\$millions)	Shareholder Equity (\$millions)	Debt-to- Equity Ratio
Verizon	\$28,646	\$48,535	0.59
FairPoint	\$607	\$225	2.70
FairPoint/Verizon NNE Pro Forma	\$2,334	\$299	7.81

Sources: FairPoint SEC Form S-4, Verizon SEC Form 10K, 2006

Merger's Impact on Combined Companies' Balance Sheets, Pro Forma, as of 12/31/06

	Verizon's Maine, New Hampshire & Vermont Operations, As Reported December 31, 2006	FairPoint As Reported, December 31, 2006	Verizon NNE and FairPoint Combined Balance Sheets, Unadjusted for the Merger, December 31, 2006	Pro Forma Combined Balance Sheet, Adjusted for the Merger, December 31, 2006	Difference Between Combined Unadjusted and Adjusted Balance Sheets	Percent Change between Unadjusted and Adjusted Combined Balance Sheets
	(\$ millions)					%
Assets						
Current assets:						
Cash and Short Term Investments	\$49	\$4	\$53	\$24	(\$29)	-55%
Accounts Receivable	172	28	200	200	0	0%
Accounts Receivable from Affiliates	30		30	30	0	0%
Prepaid and other	35	13	48	48	0	0%
Deferred income tax		34	34	26	(8)	-24%
Total current assets	286	79	365	328	(37)	-10%
Property, plant, and equipment, net	1,701	246	1,947	1,947	0	0%
Goodwill		499	499	861	362	73%
Investments		12	12	7	(5)	-42%
Intangible assets, net	5	13	18	170	152	844%
Prepaid pension asset	31		31	39	8	26%
Deferred income tax		24	24		(24)	-100%
Other	29	12	41	58	17	41%
Total assets	2,052	885	2,937	3,410	473	16%
Liabilities and Stockholders' Equity						
Current liabilities:						
Accounts payable	82	14	96	78	(18)	-19%
Accounts payable to affiliates	99		99	99	0	0%
Dividend payable		14	14	14	0	0%
Current deferred income tax liabilities	7		7		(7)	-100%
Other current liabilities	53	15	68	68	0	0%
Accrued interest payable		1	1		(1)	-100%
Current portion of long- term debt		1	1		(1)	-100%
Current portion of capital lease obligations	2		2	2	0	0%
Liabilities of discontinued operations		1	1	1	0	0%
Total current liabilities	243	46	289	262	(27)	-9%
Long- term liabilities:						
Long- term debt, net of current portion		607	607	2,334	1,727	285%
Capital lease obligations	12		12	12	0	0%
Employee benefit obligations	373		373	204	(169)	-45%
Deferred income taxes	175		175	255	80	46%
Unamortized investment tax credits	6		6	6	0	0%
Other liabilities	31	7	38	38	0	0%
Total long- term liabilities	597	614	1,211	2,849	1,638	135%
Stockholders' equity:						
Common stock			0	1	1	nm
Parent company funding	1,212		1,212		(1,212)	-100%
Additional paid- in capital		531	531	368	(163)	-31%
Accumulated other comprehensive loss, net		5	5	(70)	(75)	-1500%
Accumulated deficit		(311)	(311)		311	-100%
Total stockholders' equity	1,212	225	1,437	299	(1,138)	-79%
Total liabilities and stockholders' equity	2,052	885	2,937	3,410	473	16%

Source: FairPoint SEC Form S-4, April 3, 2007, pp. 172-173

FairPoint vs. Verizon Operating Expenses per Access Line

	2002	2003	2004	2005	2006
FairPoint					
Total operating expenses	\$157,499	\$159,292	\$179,091	\$195,815	\$208,699
Access Lines [1] [2]	241,613	246,371	239,274	243,616	251,706
Operating Expense per Access Line	\$652	\$647	\$748	\$804	\$829
<i>Year-Over-Year Change (%)</i>		-0.8%	15.8%	7.4%	3.2%
<i>Five-Year Change (\$)</i>					\$177
<i>Five-Year Change (%)</i>					27.2%

Verizon Northern New England

Total Operating Expenses (\$000)	\$1,019,000	\$1,096,000	\$997,000	\$1,078,000	\$1,082,000
Access Lines [1]	1,852,884	1,780,978	1,696,353	1,608,120	1,506,644
Operating Expense per Access Line	\$550	\$615	\$588	\$670	\$718
<i>Year-Over-Year Change (%)</i>		11.9%	-4.5%	14.1%	7.1%
<i>Five-Year Change (\$)</i>					\$168
<i>Five-Year Change (%)</i>					30.6%

Difference: FairPoint vs. Verizon NNE
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Operating Expense per Access Line (\$)	\$102	\$31	\$161	\$133	\$111
Operating Expense per Access Line (%)	18.5%	5.1%	27.4%	19.9%	15.5%
Average Five-Year Difference (\$)					\$108
Average Five-Year Difference (%)					17.3%

[1] Year-end access lines, unadjusted for intra-year changes from organic line losses or gains or for FairPoint acquisitions

[2] FairPoint began including lines from its CLEC subsidiaries, beginning with the Quarter ending September 30, 2006

NOTE: 5 year period for which comparable data is available

Sources: FairPoint SEC Form S-4 and forms 10K

FairPoint: Quarterly Change in Per Access Line Operating Expense, 1Q06-1Q07
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	Three Months Ended				
	31-Mar-06	30-Jun-06	30-Sep-06	31-Dec-06	31-Mar-07
Operating Expense (\$000)	\$49,240	\$49,627	\$53,201	\$56,631	\$62,171
<i>Quarterly Change</i>		0.8%	7.2%	6.4%	9.8%
<i>Year-Over-Year Change</i>					26.3%
<i>Less Merger-Related Expense</i>				\$2,400	\$7,600
Adjusted Operating Expense (\$000)	\$49,240	\$49,627	\$53,201	\$54,231	\$54,571
<i>Quarterly Change</i>		0.8%	7.2%	1.9%	0.6%
<i>Year-Over-Year Change</i>					10.8%
Access Lines [1]	242,191	242,176	251,763	251,706	248,366
<i>Quarterly Change</i>		0.0%	4.0%	0.0%	-1.3%
<i>Year-Over-Year Change</i>					2.5%
Adjusted Operating Expense Per Access Line	\$203.31	\$204.92	\$211.31	\$215.45	\$219.72
<i>Quarterly Change</i>		0.8%	3.1%	2.0%	2.0%
<i>Year-Over-Year Change</i>					8.1%

[1] Includes CLEC lines, beginning in 9/30/06 Quarter

Note: NNE data for the March 2007 quarter is not yet available

Sources: FairPoint Communications Forms 10K and 8K

Changes in FairPoint's Shareholder Equity Since Its 2005 IPO

	3/31/2005	12/31/2005	12/31/2006	3/31/2007
Total stockholders' equity (\$000)	\$266,698	\$249,848	\$224,719	\$209,671
Decline from Previous Period (\$000)		(\$16,850)	(\$25,129)	(\$15,048)
<i>Decline from Previous Period (%)</i>		-6.3%	-10.1%	-6.7%
Total Decline 3/31/05 to 3/31/07 (\$000)				(\$57,027)
<i>Total Decline 3/31/05 to 3/31/07 (%)</i>				-21.4%

NOTE: FairPoint consummated an Initial Public Offering and recapitalization on February 8, 2005. The quarter ended March 31, 2005 was FairPoint's first quarter subsequent to this event.

Sources: FairPoint Communications Forms 10K and 8K

FairPoint Net Income, Depreciation, Dividends and Capital Expenditures, 2002-2006
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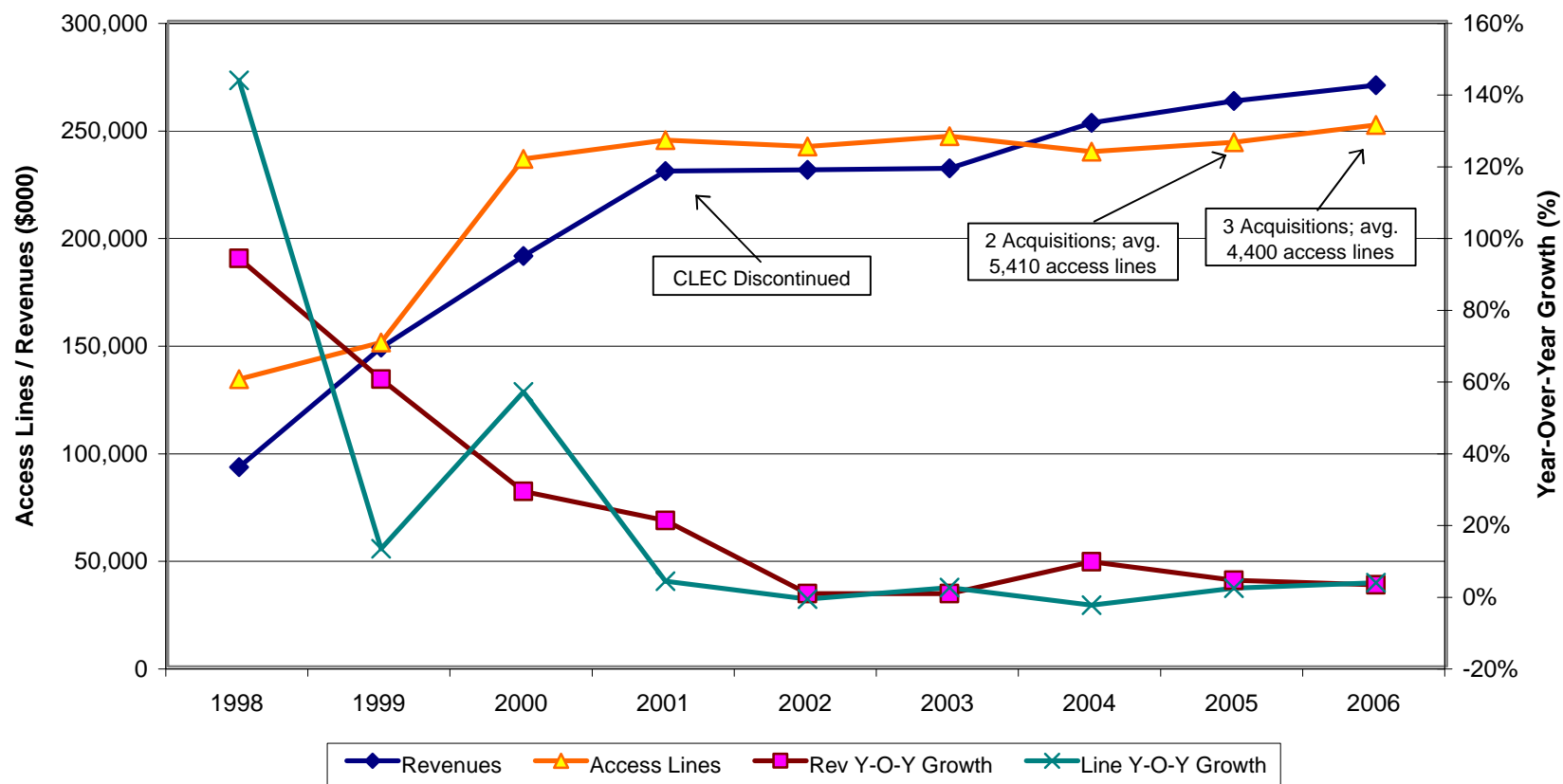
	2002	2003	2004	2005	2006
Select Financial Data	(\$000)				
Net income (loss)	13,239	1,671	(23,682)	28,930	31,090
Depreciation and amortization	46,310	48,089	50,287	52,390	53,236
Dividends [1]	n/a	n/a	n/a	35,298	55,237
Capital Expenditures	38,803	33,595	36,492	28,099	32,317

Ratios					
CapEx to Depreciation:	84%	70%	73%	54%	61%
Dividends to CapEx	n/a	n/a	n/a	126%	171%
Dividends to Net Income	n/a	n/a	n/a	122%	178%

[1] FairPoint went public in early 2005; thus its 2005 dividends were not paid on a full-year basis; 2006 more representative of the FairPoint Board of Directors' dividend policy.

Source: FairPoint SEC Form 10K, 2006

FairPoint Revenue and Access Line Growth: 1998-2006



Selected FairPoint Financial Projections: 2008 - 2015 (as of January 2007)

(\$ in Millions)	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>	2008-2015 Totals
Pro Forma Combined Revenues	\$1,427	\$1,418	\$1,421	\$1,414	\$1,404	\$1,399	\$1,397	\$1,394	\$11,274
% Y-o-Y Growth		-0.6%	0.2%	-0.5%	-0.7%	-0.4%	-0.1%	-0.2%	
Pro Forma Combined Operating Expense (excluding depreciation)	\$961	\$874	\$883	\$890	\$895	\$903	\$911	\$917	\$7,234
% Y-o-Y Growth		-9.1%	1.0%	0.8%	0.6%	0.9%	0.9%	0.7%	
Pro Forma Combined Operating Expense (including depreciation)	\$1,291	\$1,196	\$1,197	\$1,192	\$1,187	\$1,179	\$1,158	\$1,135	\$9,535
% Y-o-Y Growth		-7.4%	0.1%	-0.4%	-0.4%	-0.7%	-1.8%	-2.0%	
Net Income / (Loss)	(\$32)	\$26	\$30	\$32	\$33	\$38	\$53	\$68	\$248
% Y-o-Y Growth		-181.3%	15.4%	6.7%	3.1%	15.2%	39.5%	28.3%	
Pension & OPEB Cash Adjustment	\$27	\$29	\$30	\$31	\$33	\$34	\$36	\$37	\$257
% Y-o-Y Growth		7.4%	3.4%	3.3%	6.5%	3.0%	5.9%	2.8%	
Depreciation and Amortization	\$330	\$322	\$314	\$302	\$292	\$276	\$247	\$218	\$2,301
% Y-o-Y Growth		-2.4%	-2.5%	-3.8%	-3.3%	-5.5%	-10.5%	-11.7%	
Pro Forma Combined Capital Expenditures	\$344	\$167	\$163	\$159	\$157	\$156	\$156	\$156	\$1,458
% Y-o-Y Growth		-51.5%	-2.4%	-2.5%	-1.3%	-0.6%	0.0%	0.0%	
Dividends Paid to Common Stockholders	\$142	\$142	\$142	\$142	\$142	\$142	\$142	\$142	\$1,136
% Y-o-Y Growth		0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	
Cash Flow After Dividends (Net Increase/Decrease in Cash Balance)	(\$176)	\$81	\$82	\$81	\$74	\$67	\$54	\$26	\$289
% Y-o-Y Growth		-146.0%	1.2%	-1.2%	-8.6%	-9.5%	-19.4%	-51.9%	
Total Shareholders' Equity/(Deficit)	\$490	\$375	\$264	\$155	\$46	(\$57)	(\$145)	(\$218)	NM
% Y-o-Y Growth		-23.5%	-29.6%	-41.3%	-70.3%	NM	NM	NM	

Note: These projections were provided by FairPoint to its investment advisor, Deutsche Bank, which in turn relied upon them in rendering its fairness opinion to FairPoint's Board of Directors on January 15, 2007 (the meeting at which FairPoint's Board approved the Verizon Northern New England transaction). In its SEC Form 424B3 (final Proxy/Prospectus) dated July 19, 2007, Fairpoint explicitly states that these projections "do not reflect FairPoint's current view on the business of the combined company" (p. 74). Nonetheless, they do reflect management's view at the time that the FairPoint Board approved the transaction. In addition, as I describe in my confidential testimony, FairPoint's projections have not changed so materially as to render the January projections meaningless.

Source: FairPoint SEC Form 424B3 (final Proxy/Prospectus), July 19, 2007, pp. 74-85; "Material Projected Financial Information Provided to Deutsche Bank, Financial Advisor to FairPoint"

Selected Summary Metrics from FairPoint Financial Projections: 2008 - 2015 (as of January 2007)

(\$ in Millions)	2008-2015 Totals	M E M O	
Net Income / (Loss)	\$248	4.6	Dividends-to-Net Income
Dividends Paid to Common Stockholders	\$1,138	(\$890)	Net Income Minus Dividends
Depreciation and Amortization	\$2,301	63%	Capital Expenditures as % of Depreciation
Pro Forma Combined Capital Expenditures	\$1,458	\$843	Depreciation Minus Capital Expenditures

Note: These projections were provided by FairPoint to its investment advisor, Deutsche Bank, which in turn relied upon them in rendering its fairness opinion to FairPoint's Board of Directors on January 15, 2007 (the meeting at which FairPoint's Board approved the Verizon Northern New England transaction). In its SEC Form 424B3 (final Proxy/Prospectus) dated July 19, 2007, Fairpoint explicitly states that these projections "do not reflect FairPoint's current view on the business of the combined company" p. 74). Nonetheless, they do reflect management's view at the time that the FairPoint Board approved the transaction. In addition, as I describe in my confidential testimony, FairPoint's projections have not changed so materially as to render the January projections meaningless.

Source: FairPoint SEC Form 424B3 (final Proxy/Prospectus), July 19, 2007, pp. 74-85; "Material Projected Financial Information Provided to Deutsche Bank, Financial Advisor to FairPoint"

Lehman Brothers / Morgan Stanley Analysis of FairPoint's Cash Flow Prospects Absent the Verizon Northern New England Transaction

	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>
"Falcon Acquisition Case" ¹								
Free Cash Flow (FCF) Before Dividends (\$millions)	\$61	\$61	\$61	\$64	\$65	\$58	\$55	\$46
FCF/Share	\$1.73	\$1.71	\$1.65	\$1.65	\$1.59	\$1.37	\$1.27	\$1.06
Dividend Payout Ratio	92%	93%	97%	98%	101%	118%	125%	150%
Leverage	4.80	4.90	4.90	4.80	4.90	4.90	5.10	5.30
"Falcon Status Quo" ¹								
Free Cash Flow (FCF) Before Dividends (\$millions)	\$57	\$53	\$47	\$43	\$37	\$33	\$28	\$22
FCF/Share	\$1.64	\$1.50	\$1.33	\$1.21	\$1.06	\$0.92	\$0.79	\$0.62
Dividend Payout Ratio	97%	106%	120%	132%	150%	172%	202%	256%
Leverage	4.60	4.80	5.00	5.30	5.60	6.00	6.40	6.90

¹ "Falcon" was the code name for FairPoint

² Annual dividend assumed to be \$1.59 per share

Source: FairPoint SEC Form 424B3 (final Proxy/Prospectus), July 19, 2007, Annex C-2, p. C-2-2; Lehman Brothers / Morgan Stanley; "Project Nor'Easter, Discussion Materials," "PF Detailed Summary—\$2.715 bn Purchase Price (New Base Case); Free Cash Flow Analysis"