STATE OF NEW HAMPSHIRE

BEFORE THE

PUBLIC UTILITIES COMMISSION

DOCKET NO. DT 07-011

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

Direct Testimony of

Randall E. Vickroy

On Behalf of

The Public Utilities Commission

Of New Hampshire

August 1, 2007

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1 **Qualifications**

2 **Q. Please state your full name, employer, business address and position.**

3 A. My name is Randall E. Vickroy. I am Liberty's principal consultant for utility
4 financial matters, and my Liberty business address is 65 Main Street, Box 1237,
5 Quentin, PA 17083.

6 **Q. On whose behalf are you testifying in this proceeding?**

7 A. I am testifying on behalf of the Staff of the New Hampshire Public Utilities
8 Commission.

9 **Q. Please describe your experience and educational background.**

10 A. I received a Bachelor of Arts from Monmouth College in 1976 with a major in
11 business administration. I received a Masters of Business Administration degree
12 from the University of Denver with an emphasis in finance in 1978. In April
13 1979 I was hired by Public Service Company of Colorado, an electric and gas
14 utility, as a financial analyst in the corporate finance and planning department.
15 For the next twelve years I was employed as a financial analyst, financial
16 supervisor, director of analysis, business development manager, and assistant to
17 the chief financial officer. My responsibilities included financial planning and
18 forecasts, capital acquisition, capital spending analysis and allocation, treasury
19 operations, securitization financing, project financing, mergers and acquisitions,
20 cash management, and investor relations.

21 In 1991 I began consulting on business, corporate finance, operations and
22 affiliate issues in the electricity, natural gas, and telecommunications industries.
23 During the past 16 years I have provided consulting services to utility

1 commissions and to companies in over 25 states and in three foreign countries.
2 From 1991 through 1998 I was a senior consultant with the Liberty Consulting
3 Group. From 1999 until 2001, I was a project manager on major utility consulting
4 engagements for Deloitte Consulting. From 2001 until the present, I have again
5 consulted, primarily for Liberty Consulting.

6 I have been involved with utility business and financial issues as
7 both a practitioner and a utility management consultant for over 25 years.
8 My consulting experience includes numerous utility consulting projects with
9 Liberty Consulting Group in over 20 states, in which I had responsibility for
10 corporate finance, treasury, credit, financial forecast, capital allocation, strategic
11 planning, budgeting, affiliate relations, rate case and risk management issues.

12 Purpose of Testimony

13 **Q. Please summarize the purpose of your testimony.**

14 A. My testimony addresses the financial aspects of the proposed FairPoint/Verizon
15 transaction.

16 Description of the Transaction

17 **Q. How will the transaction be financed by FairPoint?**

18 A. The total value of the transaction to Verizon is $2.715 billion. Verizon
19 shareholders will receive one FairPoint share of stock for every 55 shares of
20 Verizon stock owned. The FairPoint stock was valued at about $1.015 billion at
21 the time of the negotiation of the transaction, which was based on a price of
22 $18.88 per share. The remaining $1.7 billion of the purchase price will be

1 financed by new debt issued by FairPoint. FairPoint's stock will be pledged as
2 security for the debt issued. (See FairPoint witness Michael Balhoff's testimony,
3 March 23, 2007, page 16, lines 7 and 8.)

4 **Q. Will FairPoint acquire additional debt financing as part of the Verizon**
5 **transaction?**

6 A. Yes. Spinco, the new Verizon entity to be merged with FairPoint, is required by
7 the Distribution Agreement to issue approximately $800 million of senior
8 unsecured notes. These notes will be exchanged for existing Verizon debt
9 securities by a third party intermediary. FairPoint will assume the Spinco senior
10 unsecured notes upon completion of the transaction. The effect of this debt
11 issuance and exchange is to increase FairPoint's debt financing required to
12 complete the acquisition of Verizon's properties to $2.35 billion. FairPoint will
13 also have an additional $400 million of debt availability following the closing of
14 the transaction; $200 million of credit capacity will be in the form of a revolving
15 credit facility, and an additional $200 million will be available through a delayed
16 draw term loan which is available only for the first twelve months after the
17 closing. (See Verizon witness Steven Smith's testimony March 23, 2007, page 15,
18 lines 5-13.)

19 FairPoint's base case financial forecast indicates that the merged
20 company's total debt will grow to almost $2.5 Billion at the end of 2008 as large
21 investments are made in the systems conversion, the DSL build-out and increased
22 "one-time" marketing and Transition Services Agreement ("TSA") expenses
23 during the first year after closing. The base forecast includes modest pay-downs

1 of debt instruments to a level of about $2.1 billion by the end of 2015. (See
2 FairPoint Confidential Attachment CFPNH 0005.)

3 **Q. What are the key characteristics of the merged FairPoint's financial**
4 **structure on a going-forward basis?**

5 A. FairPoint has proposed a highly-leveraged financial structure that has been built
6 to fund the merged company's capital expenditure and dividend levels with little
7 remaining or excess cash flow. The FairPoint base case forecast indicates the
8 following overall financial characteristics of the merged company:

9 a) moderately declining cash flow
10 b) moderately declining capital expenditures
11 c) large dividend payments that are a financial driver
12 d) a heavy debt and interest load caused by a highly leveraged
13 financial structure
14 e) low levels of book equity capital that turn negative after two years
15 f) projected interest coverage and leverage ratios that reflect highly
16 leveraged operations.

17 **Q. What are the effects of using the Reverse Morris Trust transaction on the**
18 **acquisition and capitalization of the Spinco acquisition?**

19 A. The transaction is structured as a Reverse Morris Trust (RMT) in order for it to be
20 tax-free to Verizon's current shareholders. By structuring a tax-free transaction,
21 Verizon has the objective of maximizing the after-tax sale value of Spinco. The
22 tax-free nature of the transaction allows Verizon to accept a lower price or realize
23 a higher after-tax return from the sale of the properties. Industry equity analysts

1 believe that had Verizon sold the property for cash on a taxable basis, it would
2 have realized an after-tax multiple of less than six times EBITDA, as compared to
3 the 6.3 times EBITDA multiple of FairPoint's RMT deal.

4 Another effect of the RMT structure on the transaction is its limitations on
5 potential buyers. For the transfer of assets to be non-taxable as determined by the
6 IRS, greater than 50 percent of the new entity must be owned by the stockholders
7 of the company selling the assets. This restriction limited potential acquirers of
8 the Spinco properties to companies with small market capitalizations. The larger
9 ILECs were precluded from being a buyer of Spinco if the RMT structure were
10 used. For the Spinco properties, companies such as CenturyTel, Citizens,
11 Windstream and Embarq had market capitalizations that were too high to make
12 the acquisition using the RMT structure. FairPoint, Iowa Telecommunications,
13 Consolidated Telecom and Alaska Communications were among the handful of
14 potential acquirers as a result of Verizon's preference for the RMT tax advantages.

15 A third major impact of the RMT on the transaction is its effect on the
16 financing and going-forward capital structure of the merged FairPoint. The RMT
17 requirement that FairPoint own less than 50 percent of the equity capital of the
18 merged entity causes a large portion of the Spinco sale value to be financed by
19 debt. While FairPoint may have financed the Spinco transaction with a high
20 degree of debt leverage under any circumstances, the RMT structure made higher
21 debt leverage a requirement.

22 The RMT structure also does not allow for the acquirer's book equity to
23 be marked up to the economic value of the transaction. This accounting treatment

1 means that the book equity of the merged FairPoint will not be marked up by the
2 over $1 billion level of its equity contribution to the transaction.(See FairPoint
3 witness Michael Balhoff's testimony, March 23, 2007, page 16, lines 16-19.) In
4 fact, FairPoint's book equity following the transaction is estimated by the
5 company to be less than $300 million. FairPoint's base financial forecast projects
6 that the merged company's equity capital will turn negative in 2010. (See
7 FairPoint Confidential Attachment CFPNH 0005.).

8 **Q. Have other industry companies used the Reverse Morris Trust and high**
9 **levels of debt to finance wireline spin-offs and acquisitions?**

10 A. Yes. In late 2005, Alltel Holding Corp. was formed as a wholly-owned subsidiary
11 of Alltel to hold Alltel's wireline business in connection with the expected spin-
12 off of these assets. In June 2006 Alltel completed the spin-off to its stockholders,
13 and then merged that business into Valor in a RMT transaction. In payment for
14 the wireline businesses, Alltel received the newly issued common stock of the
15 merged company, named Windstream, a special dividend financed by
16 Windstream debt, and also received Windstream debt securities to be exchanged
17 for Alltel debt securities. Upon completion of the merger, Alltel shareholders
18 owned 85 percent of Windstream's equity and Valor shareholders owned the
19 remaining 15 percent. As a result of the RMT merger transaction, Windstream
20 issued or assumed about $5.5 billion of long-term debt to finance the merged
21 company. The level of debt financing the Alltel spin-off and Valor businesses
22 increased from about $1 billion to $5.5 billion as a result of the transaction, and
23 equity capital decreased significantly to under $500 million. The debt covenants

1 in Windstream's new debt securities required maximum leverage ratios (debt to
2 EBITDA) of 4.5 to 1 and minimum interest coverage (EBITDA to interest) of
3 2.75 to 1. These debt covenant restrictions require a more conservative level of
4 debt to cash flow for Windstream than the more aggressive levels allowed in
5 FairPoint's debt agreements, which are a maximum 5.5 to 1 leverage ratio and a
6 minimum 2.25 to 1 interest coverage. In other words, FairPoint is expected to
7 have a higher amount of debt financing for each dollar of expected cash flow than
8 Windstream, as indicated by its more aggressive debt covenant limits. The
9 FairPoint transaction is more highly leveraged relative to cash flow and carries
10 more financial risk than Windstream as a result.
11 Embarq was formed similarly, as a spin-off of Sprint Nextel. In late 2004,
12 Sprint Nextel announced its intention to spin off its local communications
13 business and product distribution operations in a tax-free transaction. Embarq was
14 incorporated in 2005. In May 2006, Sprint Nextel transferred these businesses to
15 Embarq in exchange for Embarq common stock, $4.5 billion of Embarq Senior
16 Notes and a $2.1 billion cash dividend financed by Embarq debt. The spin-off
17 was completed through a distribution to Sprint Nextel shareholders of one share
18 of Embarq stock for every 20 shares of Sprint Nextel stock owned. The spin-off
19 was completed as a tax-free RMT transaction. The Embarq transaction also
20 significantly increased the degree of debt leverage supporting the spun-off
21 businesses, from about $1.1 billion at year-end 2005 to $6.4 billion at year-end
22 2006.

1 **Q. You have previously mentioned that FairPoint forecasts a negative equity**
2 **position starting in 2010. Explain how the negative equity is established, and**
3 **whether it will allow FairPoint to remain financially viable.**
4 A. As I explained earlier, the book equity value of the merged FairPoint is not
5 marked up to reflect FairPoint's contribution of over $1 billion in common stock,
6 which is measured by the market value of the stock. (See FairPoint witness
7 Michael Balhoff's testimony, March 23, 2007, page 16, lines 16-19.) FairPoint's
8 base financial forecast estimates shareholder's equity at $298 million immediately
9 following the closing date. However, FairPoint's equity position declines in every
10 year of the financial forecast, and is estimated to be negative $452 million at the
11 end of 2015. Equity capital decreases because FairPoint's dividend level of $142
12 million per year is much higher than net income in every year from 2008 through
13 2015, with a cumulative difference of $758 million. FairPoint expects to eliminate
14 its small book equity position and have 100 percent debt in its book capital
15 structure through the payment of its high dividend levels. (See FairPoint
16 Confidential Attachments CFPNH 0004 - CFPNH 0006.)
17 **Q. Could a company with 100 percent debt in its book capital structure be**
18 **financially viable?**
19 A. Yes. A company with 100 percent debt in its book capital structure can be
20 financially viable. While negative equity capital may sound as if a company is
21 insolvent, this is not necessarily the case. Net income and book equity are
22 established and important accounting measures of profitability and net worth, but
23 are not important to investors, bankers, equity analysts and credit analysts. These

1 financial professionals focus on cash flow and cash flow measures, which provide
2 a company's true ability to fund its capital expenditures, interest payments and
3 dividends. A company with negative equity capital can produce very strong
4 operating cash flow that funds capital expenditures, covers interest payments with
5 ample room to spare, and is able to have more than enough cash left over to fund
6 a healthy dividend. While this structure is not one that would fit a growth
7 business, with its need to re-invest capital in the business rather than pay
8 dividends, it can work in a predictably declining business such as wireline
9 operations.

10 **Q. Why do FairPoint and several other rural wireline consolidators have high**
11 **dividend payout levels?**

12 A. FairPoint and other wireline consolidators operate in a declining business
13 environment that offers few prospects for overall company growth. Investors in
14 common stocks tend to be most interested in high growth rates for earnings per
15 share and cash flow, which they believe will be translated by the market into a
16 higher market price, increased dividend payouts over time, or both. The fixation
17 of Wall Street on growth causes some companies in declining businesses such as
18 wireline to seek alternative ways of attracting investors to support their stock
19 price and provide access to equity capital. One means of attracting investor
20 support in a business where growth is not attainable is to pay very high levels of
21 dividends that provide the investor with a substantial current yield on their
22 investment to replace growth prospects. In the wireline business, with decreasing
23 access lines an unavoidable fact, a successful company is one that is able to

1 replace lost revenue and profit margins through ancillary businesses such as DSL,
2 long-distance growth and other non-wireline growth businesses. If a wireline
3 company is able to keep its total revenue, profit margins and cash flow level over
4 time, it would be considered successful.
5 Several of the wireline consolidators, including FairPoint, fit into the
6 category of "high dividend yield" or "full cash payout" entities. With no focus by
7 investors on growth prospects, these companies are considered pure dividend
8 plays where the ability to continue to pay the dividend is paramount. Such
9 entities are priced by the market at levels that, combined with their known
10 dividend level, provide a dividend yield of two percent to five percent above the
11 10-year U.S. treasury yield. Variations in the stock price are caused by the
12 market's confidence or lack of confidence in a company's ability to continue
13 paying the high dividend.
14 Perceived problems at high dividend yield companies that could threaten
15 the dividend will increase investor's dividend yield requirements and can have
16 devastating effects on their stock price. **[BEGIN CONFIDENTIAL]**
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1 FairPoint's stock price fell precipitously from around $16 to $10 following
2 the announcement of these problems. On the other hand, FairPoint's stock price
3 recovered quickly when the company announced soon afterward that the problems
4 were likely to cost the company almost nothing, as millions of dollars were paid
5 by the vendor in a settlement. According to another analyst, **[BEGIN**
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10 ## FairPoint Base Financial Model

11 **Q. Have you reviewed FairPoint's base case financial projections, the results of**
12 **which were included in the testimony of Walter Leach?**

13 A. Yes. The FairPoint base case financial model for 2008 through 2015 was
14 provided by the company for our review and use. The base case model that we
15 received was slightly different from that presented in Mr. Leach's testimony, as
16 the company had updated it with more recent information. The FairPoint base
17 case include forecasted financial results, income statements, balance sheets, cash
18 flow forecasts and numerous supporting schedules for the key model variables
19 through 2015.

20 **Q. Please define and explain the relevance of "EBITDA" and "dividend payout**
21 **percentage."**

22 A. The most important operating results measures shown in FairPoint's forecasts are
23 EBITDA and cash flow information and their ability to cover interest expense,

1 capital expenditures, and the sizable dividend to be paid by FairPoint. EBITDA
2 stands for "earnings before interest expense, taxes, depreciation and
3 amortization." It is a measure used by financial market analysts to represent the
4 operating cash flow of a company that is available to pay the major non-operating
5 expense expenditure categories such as interest, capital expenditures and
6 dividends. Using EBITDA allows a standardized comparison between companies
7 regarding levels of operating cash flow. EBITDA is often used as a denominator
8 in valuation ratios, as in: "FairPoint is paying Verizon 6.3 times EBITDA,"
9 denoting that the sale is valued at 6.3 times the acquired entity's operating cash
10 flow. EBITDA is also regularly used as a component of important debt covenants,
11 such as the "leverage ratio." The leverage ratio measures a company's total debt
12 to its EBITDA, or operating cash flow, to measure the relative strength of the cash
13 flow to pay for the debt outstanding.
14 An important measure from the FairPoint stockholders' point of view is
15 the ease with which dividends are paid from the free cash flow remaining after the
16 payment of interest and capital expenditures. The lower the dividend payout
17 percentage of free cash flow, the more comfortable equity investors are about the
18 company's ability to continue paying the dividend. Exhibit A provides FairPoint's
19 cash flow projections and dividend payout percentages from the base case that are
20 key financial measures regarding the cash flow health of the company.
21 **Q. Is FairPoint's projected cash flow in the base case adequate to support the**
22 **company's forecasted levels of interest, capital expenditures and dividends?**

1 A. Yes. FairPoint's projected cash flow in the base case is adequate to support the
2 company's forecasted levels of interest, capital expenditures and dividends,
3 although the dividend payout ratio climbs significantly in later years of the
4 forecast. Operating cash flow in FairPoint's base case is sufficient to pay capital
5 expenditures and the $142 million dividend, with excess cash flow remaining to
6 pay down debt in each year after 2008. (See FairPoint Confidential Attachment
7 CFPNH 0006.)

8 **Q. What are the leverage ratio and interest coverage ratio results of FairPoint's**
9 **base case, and why are they important to the wireline customers?**

10 A. The cash flow and dividend payout percentage calculations shown in Exhibit A
11 are important to FairPoint stockholders, who are concerned about the company's
12 ability to pay its high dividend level. Of more importance to creditors, rating
13 agencies and other stakeholders such as wireline customers are debt covenant
14 projections and actual results. This group of stakeholders is more interested in the
15 company's ability to pay the interest and principal on its debt obligations with
16 room to spare. These debt covenant measures become substantially more
17 important in more leveraged operations, such as the FairPoint acquisition.

18 While debt investors, banks and rating agencies are concerned with the
19 protection of debt interest and principal payments, customers and their regulators,
20 as their proxy, are also interested in the downside risks monitored and measured
21 on outstanding debt instruments. Debt covenant margins are important to the
22 protection of wireline service for a number of reasons. Small coverage margins
23 for interest payments indicate that a company may not be generating sufficient

1 funds to pay for adequate capital expenditures to maintain reliable service levels.
2 Companies with lower levels of cash flow and interest coverages may be tempted
3 to cut back on capital expenditures and leave additional funds for the payment of
4 dividends. The failure of a borrower to meet the covenants included in its debt
5 agreements may also cause lender actions that could impact service quality over
6 time. If a borrower defaults on its debt agreements, lenders would have a great
7 deal of influence on spending decisions, which might not be to the benefit of
8 service quality.

9 FairPoint's key debt covenants are a leverage ratio maximum limit and an
10 interest coverage ratio minimum limit. These restrictive debt covenants are
11 included in the term sheet commitments for FairPoint's debt financings. The
12 leverage ratio covenant limits FairPoint's total debt divided by EBITDA to no
13 more than 5.75 times in the first year following closing, and 5.50 times thereafter.
14 The interest coverage covenant limits the ratio of EBITDA divided by interest
15 expenses to 2.25 times in all years. Due to the high level of one-time
16 implementation expenses in 2008, its debt agreements allow FairPoint to add back
17 these expenses to EBITDA for debt covenant purposes in the first year only,
18 allowing easier compliance with the covenants during this transition period. (See
19 FairPoint Confidential Attachment FPNH – Trans 0481.)

20 **Q. What are the debt covenant coverages in FairPoint's base case forecast?**

21 A. FairPoint's base case results shown in Exhibit B indicate compliance with these
22 crucial debt covenants in each year of the forecast, with some room to spare. The
23 debt covenant ratios improve only slightly over the forecast period, as debt pay-

1 downs are relatively modest in relation to free cash flow due to the large dividend
2 payments to FairPoint stockholders. (See FairPoint Confidential Attachments
3 CFPNH 0004- CFPNH 0006.)

4 **Q. What are the key operating drivers of financial results in FairPoint's base**
5 **case?**

6 A. The most important drivers of financial results for FairPoint are the retention of
7 revenue levels, one-time operating expenses such as the TSA payments and
8 CapGemini fees for the back-office systems, the cost synergies forecast by the
9 company, and levels of one-time capital expenditures for DSL and required
10 system upgrades. We have reviewed FairPoint's assumptions and estimates in
11 these areas as the most important variables impacting the company's financial
12 viability.

13 **Q. What are FairPoint's base case assumptions regarding the retention of**
14 **revenue levels in the declining wireline business?**

15 A. The most important driver of revenue levels for local exchange companies is their
16 rate of loss of access lines over time. **[BEGIN HIGHLY CONFIDENTIAL]**
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3 FairPoint estimates that Spinco's local revenue on a year-over-year basis
4 will decrease by 4.8 percent from 2008 to 2009, with the rate of decline gradually
5 slowing to 2.4 percent in 2015. FairPoint expects to make up for the loss of access
6 lines and local revenue primarily through growth in UNE-Loops and Data/Internet
7 revenue. Estimated growth in these two areas almost completely offsets the local
8 revenue losses; Spinco revenue is expected to decline only 1.3 percent in total
9 from 2008 to 2015, or less than 0.2 of 1 percent annually. (See FairPoint
10 Confidential Attachment CFPNH 0004 and Walter Leach testimony, page 22,
11 lines 11-15.)
12 **Q. FairPoint has estimated that it will save significant amounts of operating**
13 **expenses by replacing Verizon's corporate allocations of costs for back-office**
14 **services with lower costs from newly-built FairPoint systems. How has**
15 **FairPoint estimated these "synergy savings"?**
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3 **Q. Do you believe that FairPoint should include these cost-saving synergies in its**

4 **base case forecast?**

5 A. No. FairPoint has not provided sufficient proof of its ability to realize synergy

6 cost savings to include them in its base case forecast. FairPoint has assumed that

7 it can save **[BEGIN HIGHLY CONFIDENTIAL]**

8 **[END HIGHLY**

9 **CONFIDENTIAL]** of Verizon's allocated costs to the Spinco LEC by replacing

10 centralized system costs from a very large corporation with newly built, stand-

11 alone back office systems. This rationale is counter-intuitive in that it contradicts

12 the sizeable economies of scale from larger, consolidated central service

13 organizations that are the driving force for many mergers. If Verizon were to be

14 acquiring FairPoint, we would expect that a component of the "merger savings"

15 justifying the deal would be that Verizon's centralized service organization could

16 provide finance, accounting, legal, marketing, IT, billing, purchasing and all other

17 support services for less than FairPoint's existing stand-alone services. Regulatory

18 commissions throughout the U.S. have been presented with information

19 supporting the savings that may be obtained by consolidating the governance and

20 support services of two companies in numerous dockets investigating proposed

21 mergers. In many cases, the rates of the acquired utility company have been

22 reduced to share the savings of consolidating support services with customers,

1 signifying the agreement of opposing parties in the docket on the concept of such
2 economies of scale.
3 FairPoint has not provided any specific proof that its projected cost
4 savings are likely to occur. The foundation of the estimated cost savings is that
5 FairPoint will be able to design, build and operate new back-office systems for a
6 specific cost of **[BEGIN HIGHLY CONFIDENTIAL]**
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9 **[END**
10 **HIGHLY CONFIDENTIAL]** However, FairPoint has never built or operated
11 this type of replacement system. Since FairPoint does not have any actual
12 experience with building this type of system, we do not have any reasonable level
13 of assurance that their cost estimates are accurate.
14 FairPoint has also not merged with or acquired any companies remotely
15 the size of Spinco, making a replacement of such sizeable support services an
16 even greater challenge. In the regulatory docket for Carlyle Group's acquisition of
17 Hawaiian Telcom, no cost savings were projected for a similar replacement of
18 Verizon's back-office services with new stand-alone services, even if that project
19 had been completed as planned. The implementation of the Hawaiian Telcom's
20 replacement back-office systems has been plagued with problems, costing that
21 company hundreds of millions of dollars. While FairPoint may consider their
22 ability to save costs on back-office systems a potential "upside" for shareholders,

1 we consider such savings to be unproven and far too speculative to include in the
2 base case forecast.
3 **Q. Are there other operating expense assumptions in FairPoint's base case**
4 **model that you believe are problematic?**
5 A. Yes. FairPoint's base case assumes that Verizon's services under the TSA will be
6 required for only five months before cut-over to the company's newly built back-
7 office systems. As noted in the Falcone/King testimony, we believe that such an
8 early cut-over is overly optimistic, and that FairPoint will have difficulty
9 completing ready-to-use back-office systems in this time frame.
10 Any extensions of TSA service usage are important financially because of
11 their extremely high cost. Verizon's TSA charges to FairPoint begin at over $14.2
12 million per month, and are increased if the TSA is extended beyond 12 months.
13 In addition, there is a fee at cutover of $34 million (after the first three months).
14 The TSA charges can be devastating to FairPoint's financial results if they are
15 increased substantially beyond the highly optimistic level included in FairPoint's
16 base case.
17 **Q. What levels of Spinco capital expenditures has FairPoint included in its base**
18 **case?**
19 A. FairPoint's base case includes recurring Spinco capital expenditures that decline
20 from $143 million in 2008 to $127 million in 2015. (See FairPoint Confidential
21 Financial Model, Summary CAPEX tab.) As shown in Exhibit E, the
22 expenditures per average line increase over the forecast due to the decline in
23 access lines. **[BEGIN HIGHLY CONFIDENTIAL]**

[END HIGHLY CONFIDENTIAL] and the DSL build-out for the Spinco properties is about $44 million in 2008. (See FairPoint Confidential Financial Model, Summary tab.)

Q. Do you believe that FairPoint's estimated levels of capital expenditures are reasonable?

A. I do not believe that all of the capital expenditure categories have reasonable estimates. The Falcone/King testimony indicates that FairPoint may have significantly underestimated the level of capital expenditures required for their broadband plan and to address service quality issues because of their lack of detailed knowledge of Verizon's network. These two categories could have significant cost overruns if the condition of the Verizon system is worse than has been assumed by FairPoint.

FairPoint "MAC" Sensitivity Analysis

Q. Did FairPoint prepare sensitivity analyses to test the merged company's financial viability with changes in key variables?

A. Yes, in at least one case. FairPoint prepared an analysis that the company called its "MAC run." The term "MAC," or material adverse change, is a term used in financial documents that denotes a major change in the borrower's business or prospects that could threaten the payment of principal and interest on debt outstanding. The FairPoint MAC analysis removes the synergy cost savings that we have questioned as being part of the base case. Because the magnitude of the synergy savings make it an important piece of the company's future cash flow

1 (ranging from 12 to 15 percent of EBITDA), FairPoint considers the MAC run to
2 be their "worst case" scenario.
3 The MAC sensitivity analysis is a very simple variation from the
4 FairPoint base case. **[BEGIN HIGHLY CONFIDENTIAL]**
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6 **[END HIGHLY**
7 **CONFIDENTIAL]** The decrease in EBITDA is not specific to either increases
8 in expense categories or decreases in revenue, but rather is meant to model the
9 financial impact of the loss of the cost synergies, a key operating income
10 component of the FairPoint base case.

11 **Q. What were the effects of the MAC sensitivity analysis on FairPoint's**
12 **dividend payout ratio and excess cash flow for debt pay-down?**

13 A. The reduction in cash flow caused by the removal of FairPoint's synergy savings
14 causes the dividend payout ratio to increase significantly. **[BEGIN HIGHLY**
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1 The significant reduction in EBITDA causes additional borrowing under
2 FairPoint's revolving credit facility. **[BEGIN HIGHLY CONFIDENTIAL]**
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7 **HIGHLY CONFIDENTIAL]** As a result, total debt and the leverage ratio
8 increase during the forecast period, as shown in Exhibit G.
9 **Q. Does the MAC sensitivity analysis indicate violations of the FairPoint's debt**
10 **covenants?**
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10 The high dividend payout ratios and the lack of any forecasted funds for
11 debt pay-down indicate that the FairPoint transaction was structured too tightly to
12 absorb the lower cash flow levels of the MAC analysis. FairPoint's high levels of
13 interest payments and dividends cannot be supported if cash flow drops
14 significantly from the company's base case.

15 **Q. Do you believe that FairPoint's MAC sensitivity analysis represents a "worst**
16 **case" scenario for the company?**

17 A. No. In my opinion, the removal of the speculative synergy cost savings in the
18 MAC case provide more of a realistic than a worst-case view of FairPoint's
19 operating expenses and cash flow. A better estimate of a "worst case scenario" for
20 a similar transaction is the recent experience of Hawaiian Telcom following its
21 acquisition from Verizon by the Carlyle Group. The Hawaiian Telcom case has
22 operational and system conversion similarities to FairPoint, in that Hawaiian

1 Telcom also attempted to re-establish back office functions previously provided
2 by Verizon, with very poor results.

3 **Hawaiian Telcom**

4 **Q. Please describe the acquisition of Hawaiian Telcom by Carlyle Group.**

5 A. Carlyle Group acquired Hawaiian Telcom from Verizon in April 2005. The
6 acquisition was in the form of a leveraged buyout, but was not structured as a
7 Reverse Morris Trust. Carlyle is a private equity investment firm that controls
8 several telecommunications and media businesses, none of which are ILECs other
9 than Hawaiian Telcom. Carlyle did not include specific quantifiable merger
10 benefits such as cost reductions or synergies in its application or testimony in the
11 regulatory docket. As in the case of FairPoint, back office functions that have
12 been traditionally provided by Verizon were to be re-established with newly built
13 back office systems at Hawaiian Telcom.

14 **Q. What were the primary concerns of the Hawaii Public Utility Commission**
15 **regarding the Carlyle acquisition of Hawaiian Telcom?**

16 A. In its March 2005 Order, the Hawaii commission stated its belief that there were
17 risks associated with Carlyle's undertaking of re-establishing Verizon Hawaii's
18 back-office systems in the originally projected nine-month period. The
19 commission also noted that the recognized implementation risks were not
20 outweighed by any substantive benefits put forth by Carlyle, and that the risks
21 associated with Carlyle's transaction were unacceptable absent mitigating
22 regulatory conditions.

1 The approval of the Carlyle acquisition was made contingent upon Carlyle
2 and Hawaiian Telcom meeting numerous conditions, of which the following were
3 the most important:
4 a) Carlyle was to infuse additional equity (and decrease debt) by approximately
5 $110 million in its proposed capital structure;
6 b) Any dividends from Hawaiian Telcom were to be earmarked and used only
7 for debt repayment until a target consolidated capital structure of 35 percent
8 book equity and 65 percent debt was achieved;
9 c) Hawaiian Telcom would not be allowed to apply for a general rate increase
10 with a test year earlier than 2009;
11 d) Hawaiian Telcom could not recover transaction or transition costs in any
12 future rate case; and
13 e) Hawaiian Telcom was to abide by a stipulation agreement signed with two
14 CLECs regarding specific requirements and milestones for the back-office
15 systems implementation.
16 **Q. Please describe the financial projections that were included as part of**
17 **Carlyle's state regulatory application for approval of the Hawaiian Telcom**
18 **acquisition.**
19 A. Financial projections were included in the application for year-end 2004 through
20 2014. The forecast did not include any dividends paid to parties outside of the
21 holding company. Free cash flow after capital expenditures was consistently used
22 to pay down debt within the holding company. Over 10 years, total debt was
23 forecast to be paid down by over $1 billion. Expenses increased slightly

1 throughout the forecast, as no cost savings or synergies were included. Total
2 access lines, excluding UNE loops, were forecast to decrease at a compound rate
3 of 1.3 percent annually for 2004 through 2009.

4 **Q. Did Carlyle/Hawaiian Telcom's actual financial performance meet its**
5 **financial forecasts for 2005 and 2006?**

6 A. No. In fact, the Hawaiian Telcom acquisition by Carlyle has had major problems
7 both operationally and financially. The back office system implementation
8 problems have caused huge financial losses for Hawaiian Telcom in both 2005
9 and 2006. Mr. Falcone and Mr. King include a description of the operational
10 aspects of these problems in their testimony. From a financial point of view, the
11 implementation problems have caused accelerated access line losses, revenue
12 decreases, huge operating expense increases, net income losses of $320 million
13 over two years, and severely decreased operating cash flow as measured by
14 EBITDA. Exhibit H compares key financial measures forecast for Hawaiian
15 Telcom with actual results experienced in 2005 and 2006.

16 Hawaiian Telcom experienced net income losses of $175.7 million in
17 2005 and $144.6 million in 2006, or a negative difference from their forecasts of
18 about $293 million over these two years. Access line losses, forecast at 1.3
19 percent per year, were 6.3 percent and 6.6 percent in 2005 and 2006, respectively.
20 The crucial "adjusted EBITDA," or operating cash flow that is included in the
21 debt covenant ratios, was almost $400 million less than that included in the
22 financial forecast over less than two years. We have calculated Hawaiian
23 Telcom's leverage ratios (adjusted for lender allowances for estimated first-year

1 transition costs) at 15.7 times and 30.2 times in 2005 and 2006, respectively.
2 According to the Hawaiian Telcom 2005 Credit Agreement, leverage ratios of
3 6.75 times or more would cause a covenant violation.

4 **Q. What have been the financial market consequences of the implementation**
5 **failures at Hawaiian Telcom?**

6 A. Since Carlyle is a private equity firm, there has not been a stock price impact.
7 However, Standard & Poor's lowered the already speculative debt rating for
8 Hawaiian Telcom from B+ to CCC+ plus in late 2005. The potential for raising
9 additional debt funding from market sources has been severely impaired or
10 eliminated as a result.

11 Hawaiian Telcom's very poor financial results indicate that the company
12 has been in violation of the leverage ratio and interest coverage ratio debt
13 covenants included in its credit agreements filed with its SEC S-4. The work-out
14 arrangements between the lenders and the company are not visible to the public,
15 but in similar circumstances lenders effectively run the company, and make the
16 decisions on all financial and spending issues. Both the Hawaiian Telcom Chief
17 Financial Officer and Chief Accounting officer left the company in early 2007.

18 In addition, on May 1, 2007 the company agreed to sell its directory
19 publishing business for $435 million, a move that was obviously made in order to
20 raise cash at the financially strapped company. In a related development, on June
21 1, 2007 Hawaiian Telcom and its parent holding company executed an amended
22 and restated credit agreement with Lehman Commercial Paper and J.P. Morgan
23 Chase. The revised agreements allowed for the sale of the directory business and

restructured the Hawaiian Telcom and holding company debt. The proceeds from the sale of the directory business were used as part of the financial restructuring, and the lender's long-term debt commitments were decreased by more than $400 million. The restructuring of debt facilities under such negative financial circumstances undoubtedly also increased the costs of debt and decreased the financial flexibility of Hawaiian Telcom on a going-forward basis.

Q. Have you prepared a FairPoint sensitivity analysis that models the financial impacts of the Hawaiian Telcom situation, including problems with the conversion of back office systems?

A. Yes. Using the FairPoint base case as our starting point, we have prepared a financial model analysis that reduced FairPoint's EBITDA for two years in the amounts that Hawaiian Telcom fell short of its forecast EBITDA in 2005 and 2006, the first two years of the acquisition. By reducing EBITDA (and using the same analysis method as the company in its MAC analysis), we are recognizing that the financial impacts of a failed back office conversion would probably include decreased revenue from incremental access line losses and delayed product roll-outs, as well as greatly increased operating expenses. We note that Hawaiian Telcom's back-office implementation is still not completed, and its financial impacts continue to hamper the company.

Specifically, the Liberty sensitivity analysis reduces FairPoint EBITDA by $177 million in 2008 and $219 million in 2009, mirroring the Hawaiian Telcom EBITDA impacts in 2005 and 2006. We note that Spinco has almost twice as many access lines and twice the revenue of Hawaiian Telcom, making the use of

1 Hawaiian Telcom's financial impacts somewhat conservative if FairPoint
2 experiences the same level of implementation problems. In the years after 2009,
3 we have reduced FairPoint's EBITDA by the same **[BEGIN HIGHLY**
4 **CONFIDENTIAL]**
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6 included in the company's MAC analysis, recognizing that some level of
7 customer loss, revenue decline and additional operating expenses would be
8 permanent with an implementation failure similar to that at Hawaiian Telcom.
9 **Q. What were the results of your sensitivity analysis?**
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3 **Q. What will happen if FairPoint violates its debt covenants by large margins**
4 **and for multiple periods, as in your sensitivity analysis?**

5 A. FairPoint has entered into commitment letters with lenders for its term loans,
6 revolving credit facility, and delayed draw term loan. The actual debt documents
7 will not be signed until the closing date of the transaction. The debt commitment
8 letters have provided the key covenants and restrictions that will be included in
9 the debt agreements, but are not specific on all terms.

10 The description of the revolving credit facility states that if FairPoint
11 violates the leverage ratio covenant, it will be prohibited from making dividend
12 payments for the quarters that they are in violation. FairPoint is also subject to a
13 cumulative dividend limit that is calculated using cumulative EBITDA less a
14 multiple of cumulative interest expense. (See FairPoint Attachment FPNH 0015.)
15 The omission or reduction of FairPoint's dividend payments would have an
16 immediate and devastating effect on the company's stock price. FairPoint's stock
17 price would be reduced drastically, making the company's access to equity capital
18 unattractive and very difficult. As a result, the violation of the leverage financial
19 covenant would have far-reaching implications, even before the lenders decide
20 whether to proceed against FairPoint with any eventual default remedies.

21 Another serious financial consequence of debt covenant violations are
22 mandatory prepayments on the Term Loan B facilities, which are the largest
23 source of funds to FairPoint at an estimated $1.55 billion. If FairPoint violates the

1 leverage covenant in the Term Loan B agreement, it must make mandatory
2 prepayments of the term loan with 50 percent of the combined company's "excess
3 cash flow," which is not specifically defined in the commitment letter. Mandatory
4 prepayments of the term loan are also required with the proceeds of any asset
5 sales or debt issuances, both of which are severely restricted by the financing
6 agreements. (See FairPoint Attachments FPNH 0014 and 0015.)
7 Violations of debt covenants that are not remedied will usually lead to a
8 "work-out" process with lenders, which can go a number of directions and could
9 lead to cuts in operating and capital expenditures. In the case of Hawaiian
10 Telcom, lenders forced the sale of the directory business as part of a debt
11 restructuring and work-out process.
12 **Q. Would FairPoint have access to the equity and debt markets to raise**
13 **additional funds for its ongoing operations if it violates its debt covenants?**
14 A. FairPoint would not have access to the equity and debt markets to raise additional
15 funds at reasonable costs of capital. As I have mentioned previously, tripping the
16 leverage ratio covenant would cause FairPoint to omit its dividend, making access
17 to equity markets very difficult. Access to debt markets would also be very
18 difficult, as the FairPoint debt commitment letters place restrictions on additional
19 debt, liens, mergers, consolidations, liquidations, distributions and other payments
20 in respect of capital stock. In other words, Lehman Commercial Paper, Bank of
21 America and Morgan Stanley have lined up a complete financing package for the
22 merged FairPoint, and are not going to allow debt from other sources that would
23 place other creditors into the recovery payment hierarchy with their unsecured

1 indebtedness such as the revolving credit. (See FairPoint Attachments FPNH
2 0013 – FPNH 0015.) Only lenders specializing in distressed situations would be
3 available to provide capital at grossly inflated interest rates.

4 **Q. What is your opinion of the violation of debt covenants in the MAC case and**
5 **the Liberty sensitivity analysis?**

6 A. The violation of the covenants of debt agreements is an unacceptable result for a
7 regulated wireline company. Debt covenant violations raise the possibility that a
8 lender may not only be making financial decisions in a default situation, but could
9 be the eventual "owner" of FairPoint. FairPoint's capital stock has been pledged
10 as collateral in the debt agreements, (See FairPoint Attachment FPNH 0013.)
11 giving lenders even more control in the case of financial difficulties. FairPoint
12 also does not have a valuable directory business that could be sold to help satisfy
13 lenders, as was the case with Hawaiian Telcom.

14 The FairPoint transaction and ongoing financial structure must be robust
15 enough to handle reduced levels of cash flow such as that modeled in the MAC
16 case. This is especially important due to our belief that FairPoint's synergy
17 savings are speculative in nature, and that the MAC case is closer to the "most
18 likely" case than FairPoint's base case. On the other hand, we recognize that even
19 changing the financial structure significantly would not prevent a violation of
20 financial covenants if FairPoint experiences system implementation problems as
21 severe as those at Hawaiian Telcom.

Summary and Recommendations

Q. Please summarize your positions regarding the financial aspects of the FairPoint/Verizon joint proposal.

A. The proposed FairPoint transaction includes a highly leveraged structure combined with a very healthy dividend payout. The merged company's cash flow generation must be strong enough to cover its three primary uses of funds: interest expense of $160-$170 million per year, capital expenditures of $160-$170 million per year and dividends of $142 million per year. (See FairPoint Attachments CFPNH 0004 – CFPNH 0006.) FairPoint's cash flow must also be strong enough to meet the crucial financial covenants included in its debt agreements. The failure to meet these covenants would cause forced dividend cuts, mandatory prepayments of debt, and the potential loss of control of the company to lenders. (See FairPoint Attachments FPNH 0013- FPNH 0015.) We consider this scenario to be unacceptable and inconsistent with ensuring the continued provision of reliable wireline service and desired new products.

FairPoint's financial forecasts project cash flow and financial results highly dependent on revenue and expense estimates for the wireline business. The revenue and locally-based operating expenses are generally predictable, since FairPoint is inheriting established operations with a long history and defined trends. Wireline companies are most concerned with controlling the loss of access lines and related revenue, while replacing their revenue and profit margins with growth in other product offerings. Liberty believes that FairPoint's estimates of revenue and non-support operating expenses are generally reasonable and based on established Verizon history and trends.

1 However, one component of FairPoint's proposal stands out as being
2 relatively unknown and highly speculative in nature. That component is
3 FairPoint's replacement of back-office services provided by Verizon with newly
4 built and operated systems. A key area of uncertainty with the conversion project
5 is the ability to implement the project on schedule and for it to be fully functional
6 at the cut-over date from Verizon systems. Mr. Falcone and Mr. King include
7 substantial information in their testimony regarding the system implementation
8 and conversion process, which is obviously difficult to execute cleanly. The
9 Hawaiian Telcom experience with a similar conversion process is one that must
10 be avoided.
11 The conversion and implementation of these new systems is crucial to
12 several areas with large financial impacts. The most important financial factor
13 driven by the system conversion is FairPoint's estimated synergy cost savings.
14 FairPoint is representing in its base case forecast that the system conversion cost
15 will be a defined dollar amount, will be implemented and operations transferred
16 on schedule, and operate cleanly from the start. On top of this, the company
17 predicts that it will save **[BEGIN HIGHLY CONFIDENTIAL]**
18 **[END HIGHLY**
19 **CONFIDENTIAL]** of the back office costs from Verizon's allocations by
20 creating this new system. The synergy savings assumption, at 12 to 15 percent of
21 EBITDA, is crucial to FairPoint's financial results, as proven by the company's
22 MAC analysis. **[BEGIN HIGHLY CONFIDENTIAL]**
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4 **[END HIGHLY CONFIDENTIAL]**
5 A second crucial financial driver related to the back-office systems
6 conversion are the TSA payments to Verizon at over $14.2 million per month.
7 FairPoint has estimated that these payments will be made for only five months,
8 which we believe to be overly optimistic. Delays in the development of the
9 replacement back-office systems will cause additional expenses above those
10 included in the FairPoint base case and the MAC case. Incremental costs for an
11 extra 12 months of TSA usage would be more than $175 million.
12 Thirdly, the back-office systems project includes substantial capital
13 expenditures and one-time expenses for building the replacement systems. Total
14 capital and operating expenses for the project are estimated at about **BEGIN**
15 **HIGHLY CONFIDENTIAL]**
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17 Estimating these costs is extremely difficult, as FairPoint does not have
18 experience with either the type or scope of this project.
19 Our focus on three financial forecast outcomes emphasizes the importance
20 of the system conversion issue. The company's base case assumes that the project
21 will be implemented on time, on budget, operate smoothly and additionally create
22 **[BEGIN HIGHLY CONFIDENTIAL]**
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1 **HIGHLY CONFIDENTIAL]** as compared to previous Verizon costs. We
2 believe that the confluence of all of these conversion successes to be highly
3 unlikely and overly optimistic, especially considering FairPoint's lack of
4 experience with such a project. The "MAC case" eliminates the cost savings
5 synergies of the system conversion in every year of the forecast. We believe that
6 this case is more reasonable than the base case, as we believe that the synergies
7 are inherently speculative. However, the MAC case includes FairPoint's
8 assumption that the TSA and its high costs will be necessary for only five months,
9 which we believe is an unreasonable assumption. Including an extended TSA
10 period in the MAC case would make debt covenant violations a certainty, and the
11 transaction would clearly not be financially viable.
12 The Liberty sensitivity case adjusts the FairPoint base case for the
13 financial effects of the Hawaiian Telcom experience, which includes the failure to
14 meet of many key pre-acquisition assumptions. The dangers of FairPoint's
15 experiencing a similar fate are real, and must be avoided. Liberty believes that
16 specific conditions on the system conversion suggested by Mr. Falcone and Mr.
17 King can mitigate severe financial consequences of the magnitude experienced at
18 Hawaiian Telcom.
19 From a financial structure perspective, only the most optimistic forecast,
20 the company's base case, succeeds financially. **[BEGIN CONFIDENTIAL]**
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1 **[END CONFIDENTIAL]** The "worst-case" Hawaiian Telcom scenario would
2 certainly result in covenant violations, the elimination of dividends, mandatory
3 debt prepayments, and a default scenario, unless mitigated with specific
4 developmental conditions.

5 **Q. Does the recent tightening of the leveraged finance markets have implications**
6 **for the FairPoint debt financing package?**

7 **A.** The recent credit crunch in corporate debt markets would make any attempt to
8 negotiate more favorable terms for FairPoint's debt financing much more difficult.
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15 During the past two months, the debt market has shifted as investors have
16 become resistant to buying the speculative grade bonds that have financed the
17 recent leveraged buyout boom, including transactions such as the
18 FairPoint/Verizon deal. While a period of "easy credit" fueled the buy-out surge,
19 that phenomenon has abruptly ended in the past two months. According to the
20 Wall Street Journal, debt investors are on a "buyer's strike" of recent debt deals
21 that offer lower interest rate premiums and less restrictive covenants than might
22 historically have been the case for speculative debt issuances. Standard and Poor's
23 notes in its July 19, 2007 commentary that "Leveraged finance's cash engine – the

1 Collateralized Loan Obligation market – has ground to a halt." The FairPoint
2 debt financing commitments that fund the transaction were signed in January
3 2007, when credit markets were very receptive to highly leveraged financing
4 deals.
5 Bankers are currently delivering the news to potential buyout clients that
6 their debt is going to be far more expensive, and that investors won't back deals
7 that entail too much borrowing or easy terms. The Wall Street Journal also notes
8 that some bankers are saying that speculative financing deals might cost up to
9 four percentage points more than just a few weeks ago. **[BEGIN**
10 **CONFIDENTIAL]**
11 **[END**
12 **CONFIDENTIAL]** is far less attractive to investors in this market than when the
13 commitment was made in January, meaning that the lead bankers on the debt
14 deals may have trouble selling the debt, and are probably not looking favorably at
15 the FairPoint commitments.
16 The FairPoint funding levels and terms are locked in by the debt
17 commitment letters. The FairPoint debt commitments allow the lenders to back
18 out of the deal only if a "material adverse effect" occurs to significantly change
19 the business prospects of the merged company. On the other hand, it is highly
20 unlikely that lenders will look favorably on any requests by Fairport to loosen the
21 covenant terms during the crucial first two years following closing, as may be
22 required for the company to avoid defaults if the system conversion does not go
23 smoothly.

1 **Q. Would you recommend financial conditions to increase the probability of**
2 **FairPoint's continued financial viability?**
3 A. Yes. Our objective with both operational and financial conditions would be to
4 greatly lessen the possibility of the "worst-case scenario" and to make the MAC
5 case, if it occurs, one that allows FairPoint to retain financial strength and capital
6 market access. These conditions should include the following major protections,
7 or various combinations of the protections:

8 - A substantial reduction in the initial debt financing for the transaction
9 - A reduction of or maximum level of TSA costs
10 - Reduction or elimination of dividends in certain financial situations
11 - Review and approval of the final debt agreements prior to their signing
12 - Relaxation of debt financial covenants until completion of the conversion
13 project
14 - A moratorium on rate increases for a specified period of time
15 - Required capital expenditure levels at forecasted dollars or above
16 - Operational conditions on the system implementation (in the Falcone/King
17 testimony)

18 **Q. Would you recommend that the joint application be approved without a**
19 **package of protective conditions?**
20 A. No. I believe that the risks of the proposed transaction to the ongoing financial
21 viability of the Spinco properties are too high as currently proposed.
22 **Q. Do you believe that it is possible to craft a package of conditions that will**
23 **provide the Commission with sufficient comfort about the ability of**

1 **FairPoint to withstand future uncertainties without posing unacceptable**
2 **risks to the ability to provide safe, adequate, and reasonable service**
3 **economically to New Hampshire's residents and businesses?**

4 A. It remains to be seen whether a package of conditions that will address these
5 concerns is possible. The testimony of Mr. Falcone and Mr. King indicates the
6 need for significant changes that will affect financial results. We look forward to
7 discussion with the applicants about those changes, and ensuing discussions about
8 a package of accompanying financial changes or conditions that will complement
9 them. The interaction of these operational and transitional changes and the
10 complementary financial changes makes it impracticable to present at this time a
11 prescriptive approach. In other words, until we see what happens in the give and
12 take we expect to occur in the next several weeks, we cannot answer the question.

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

14 A. Yes, it does.

Exhibit A

FairPoint EBITDA and Uses of Funds, 2008-2015

Dollars in Millions

	2008	2009	2010	2011	2012	2013	2014	2015
EBITDA	$435	$546	$541	$525	$510	$497	$486	$487
Less:								
Interest Expense	168	168	165	162	159	157	156	155
Cash Taxes	(18)	30	37	36	36	39	41	42
Capital Expenditures	325	167	164	159	157	156	156	156
Free Cash Flow	(40)	181	175	168	158	145	133	134
Dividends	142	142	142	142	142	142	142	142
Excess Cash Flow/ (Added Debt)	(182)	39	33	26	16	3	(9)	(8)
Dividend Payout Percentage	N/A	78%	81%	85%	90%	98%	107%	106%

Source: FairPoint Confidential Attachments CFPNH 0003 – CFPNH 0006

Exhibit B

FairPoint Capitalization and Financial Covenant Coverages

Dollars in Millions

	2008	2009	2010	2011	2012	2013	2014	2015
Term Notes	$1,550	$1,550	$1,533	$1,462	$1,401	$1,354	$1,319	$1,294
Revolving Credit	138	58	0	0	0	0	0	0
Exchanged Bonds	793	793	793	793	793	793	793	793
Other	4	4	2	2	1	1	1	1
Total Debt	2,485	2,406	2,328	2,256	2,196	2,149	2,113	2,088
Shareholder's Equity/(Deficit)	130	36	(48)	(133)	(218)	(298)	(376)	(452)
Credit Ratios								
Interest Coverage	3.08	3.25	3.26	3.22	3.19	3.15	3.12	3.08
Covenant Minimum	2.25	2.25	2.25	2.25	2.25	2.25	2.25	2.25
Leverage Ratio	4.80	4.40	4.30	4.30	4.31	4.32	4.35	4.37
Covenant Maximum	5.75	5.50	5.50	5.50	5.50	5.50	5.50	5.50

Source: FairPoint Confidential Attachments CFPNH 0003 – CFPNH 0006

Exhibit C

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Exhibit D

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Exhibit E

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Exhibit H

Hawaiian Telcom – Two-year Forecast Shortfalls, 2005 and 2006

(Dollars in Millions)

	2005	2006	Two-year Total
Net Income			
Carlyle Forecast Hawaiian Telcom Actual	$(60.3) $(175.7)	$33.2 $(144.6)	$27.1 $(320.3)
NI Shortfall from Forecast	$(115.4)	$(177.8)	***$(293.2)***
EBITDA	(First year includes OPEX add-back)		
Carlyle Forecast	$261.9	$265.5	$527.4
Hawaiian Telcom actual	$85.4	$45.7	$131.1
EBITDA Shortfall from Forecast	$(176.5)	$(219.8)	***$(396.3)***
Total Access Lines (excluding UNE)			
Carlyle Forecast	(1.3)%	(1.3)%	
Hawaiian Telcom Actual	***(6.3)%***	***(6.6)%***	
Leverage Ratio (Total Debt/EBITDA)			
Carlyle Forecast	5.7X	5.4X	
Hawaiian Telcom Actual	***15.7X***	***30.2X***	
Coverage Ratio (EBITDA/Interest)			
Carlyle Forecast	2.2X	2.2X	
Hawaiian Telcom Actual	***1.08X***	***0.40X***	

Exhibit I

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