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

John Antonuk

On Behalf of

The Public Utilities Commission

Of New Hampshire

August 1, 2007

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Qualifications

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

A. My name is John Antonuk. My business address is 65 Main Street, P.O. Box 1237, Quentin, Pennsylvania 17083. I am a founder, and serve as the president of The Liberty Consulting Group.

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

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

Q. Please describe your experience and educational background.

A. I have over 30 years of experience in the utility industry and in utility regulation. I began my career in 1975, in the office of the General Counsel of the Pennsylvania Public Utility Commission, addressing a variety of energy and telecommunications matters. I then moved to Pennsylvania Power & Light Company, a large Northeastern electric utility, where I served first in the Legal Department. Later, I became the head of the Services and Facilities Section of the Regulatory Affairs Department. I served as a primary liaison for the company with the staff and members of the Commission and I handled a wide variety of administrative litigation.

I left the company around 1981 to begin consulting. I worked for a number of years as the manager of the regulatory consulting practice for a firm (Management Analysis Company) with a nationwide utility industry client base. I was one of Liberty's founders in 1987 and I have served as its president for many years. I have led the firm's utility regulatory commission practice since it began around 1990. I have managed or directed 150 or more engagements for utility regulatory commissions or their staffs.

Liberty's utility regulatory practice extends to more than 35 U.S. jurisdictions and a number in Canada as well.

I received a bachelor's degree with honors from Dickinson College and a law degree with honors from the Dickinson School of Law. I have attached to this testimony Exhibit A, which summarizes my professional experience.

Q. Have you testified previously in New Hampshire?

A. Yes; I testified in the PSNH restructuring proceedings before this Commission and state legislative committees. I also testified for Governor Shaheen's office in the Northeast Utilities/Consolidated Edison proceedings before this Commission. I also testified about the treatment of Verizon yellow pages revenue for regulatory accounting purposes before this Commission.

Q. Have you testified before other state public service commissions on merger or acquisition proceedings?

A. Yes; I testified for the commission staff before the Arizona Corporation Commission in the proposed acquisition of UniSource (a major state electric and gas utility, whose principal subsidiary is Tucson Electric) by private equity interests. I also testified for a group of industrial intervenors before the Public Utility Commission of Oregon in the proposed acquisition of Portland General Electric by private equity interests.

Q. Please describe Liberty's experience in dealing with telecommunications issues.

A. Liberty has been examining telecommunications issues for utility regulatory commissions for more than a decade. Our work began with the performance of management and operations and affiliate audits. We have performed for state utility regulatory commissions comprehensive management audits of Bell Atlantic Pennsylvania and of

GTE Kentucky. We have performed for state utility regulatory commissions affiliate transaction and relationships audits of Bell Atlantic Pennsylvania, Maryland and the District of Columbia. We performed a similar audit of New York Telephone Company. We have also performed affiliates and earnings reviews for state commissions of Verizon New Jersey and New Hampshire. Liberty has extensive experience in dealing with the rate, technical, operating, administrative, and all other aspects of interconnection agreements between incumbent and competitive local exchange carriers.

I have served for Liberty in a variety of roles in telecommunications arbitrations, SGAT proceedings, and state Section 271 reviews, acting as arbitrator, administrative law judge, staff expert and commission advisor. For example, I conducted a combined proceeding for nine-state commissions addressing Section 271 approval for Qwest, where my responsibilities included the provision of recommended resolutions of all of the issues raised by more than a dozen CLECs, a number of consumer advocates, and state commission staffs.

Q. Have you performed similar work for commissions in the energy industry?

A. Yes; we have performed many such studies for commissions across the country and in Canada.

Purpose of Testimony

Q. Please summarize the purpose of your testimony.

A. My testimony addresses the standards against which the Liberty witnesses have evaluated the acquisition by FairPoint and the evidence that FairPoint and Verizon have submitted in support of that acquisition. I provide an overview and consolidated statement of the major issues addressed and the conclusions reached by Liberty in its examination of the proposed acquisition. I summarize the financial issues addressed in the testimony of Randall Vickroy and the operational issues addressed in the testimony of Robert Falcone, and Charles King. I address governance and senior management issues, yellow pages revenue, synergy expectations, and regional and community involvement issues.

Summary of Testimony

Q. Please summarize your testimony.

A. On behalf of Staff, this testimony and that of Robert Falcone, Charles King, and Randall Vickroy list and detail the reasons why the Commission should not approve the joint application as currently proposed by the applicants. A combination of financial and other risks make it impossible to conclude that the acquisition by FairPoint of Verizon's critical public service responsibilities in New Hampshire will be for the public good.

Concerns in the areas of financial leverage, dividend-dependence, broadband plans and commitments, other network issues, the Transitional Services Agreement (TSA), back-office system integration, staffing, network service quality, retail and wholesale service, management, staffing, governance, synergies, yellow pages revenue, and regional and community involvement underlie this conclusion.

We have not concluded that that these concerns are irresolvable. We look forward to the opportunity to address them through the settlement process that the Commission has provided. We intend to participate constructively and flexibly in those discussions. We do not expect resolution to be easy, but we approach the discussions with an open mind. We are prepared to report candidly and promptly to the Commission any agreements reached, in order to provide as complete a framework as we can for addressing and resolving the many and complex issues that the Commission will need to decide in addressing the questions raised by the joint application.

Application of the Public-Interest Standard

Q. What is Staff's source for the standard that it has applied in reviewing the proposed acquisition?

A. Staff used Title XXXIV, Section 374:30 "Other Public Utility Leases, etc." as the basis for its standard. This section governs a public utility's transfer or lease of all or part of its "franchise, works or system." Such a transfer may occur only after a Commission finding that such transfer "will be for the public good."

Q. Please provide some general context for applying the standard applicable in this proceeding.

A. Verizon has been serving as New Hampshire's largest local exchange service provider for many decades. The company is one of the world's largest telecommunications service providers. It serves over 45 million access lines and it operates a leading, nationwide wireless business. It has 242 thousand employees and its finances have been notably strong for a long time.

FairPoint does not have these advantages; it has been in existence for 16 years, has 952 employees, and serves approximately 311 thousand access lines, with less than one percent of them in New Hampshire. These figures are from FairPoint's 10-K filing for the fiscal year ending December 31, 2006. FairPoint therefore does not come to New Hampshire with a track record sufficient either in scope or duration that makes it easy to conclude that it will be able to continue to provide the current level of service or prices to New Hampshire residents and businesses, let alone improve them materially.

This is not to say that FairPoint cannot succeed as New Hampshire's dominant local exchange provider. The company has assembled a strong executive team, and has provided for maintaining the workforce, supervision, and management that Verizon has been using to serve New Hampshire. FairPoint has adopted plans and retained expert resources to replace the systems that Verizon has used to support operations for retail and for wholesale customers. FairPoint has also provided for the transition period by retaining the services of Verizon through a Transition Services Agreement (TSA). In addition, FairPoint has sought to assure that it will continue to meet many of Verizon's commitments to various stakeholders as they are now defined; *e.g.*, retail tariffs, wholesale agreements, labor agreements, and cost allocations. FairPoint has also committed to maintain the interconnection agreements and contracts with other telecommunications providers such as independent companies, wireless carriers and cable companies, for example.

It is clear that FairPoint has made a very substantial commitment to preparing itself to become a much bigger provider than it has been to date. It seems reasonably clear that growing its size is central to its strategy, which is to provide value to shareholders in a declining (*i.e.*, wireline telecommunications) business by providing consistent, high dividend yields.

Q. How, overall, should the Commission view FairPoint's commitments?

A. The key question for the Commission to answer is not whether FairPoint's commitments have been massive or in good faith; they clearly have been. The key questions are whether those commitments are sufficient, whether they are credible, and whether FairPoint is positioned to meet them.

Q. Please discuss the degree to which you consider the public-interest to be objectively measurable.

A. The framework for answering that question is a proper definition of the "public interest," which comprises the standard by which this acquisition must be judged under New Hampshire law. There is here, as there has been in the past, argument about whether the public interest test means "no net harm," on the one hand, or "positive benefits" on the other hand. We believe that this debate does not shed substantial light on the challenge facing this Commission, as it makes what may prove to be the most significant decision affecting the adequacy, reasonableness, and economy of telecommunications service for the future of New Hampshire. Framing the debate in this overly simplistic manner suggests that there is some tangible way of measuring with a high degree of confidence whether the effects of this acquisition will be positive or negative.

That simply is not the case. Success in operating the local-exchange business for most of New Hampshire requires effective planning, budgeting, governance, organization, staffing, policies, procedures, systems, controls, work execution, performance measurement, stakeholder management, regulatory and legislative interface, and regional and community involvement in an array of areas almost too numerous to mention. How Verizon will continue to operate is by no means certain; how FairPoint will operate is even more speculative.

Q. How should the Commission address future uncertainties in judging this acquisition against the applicable standard?

Settling for maintenance of current conditions or securing very marginal improvements should not be considered sufficient where operating and financial uncertainties impose significant future risks. We believe that the Commission should place significant value on future uncertainties as it weighs the question of whether FairPoint's assumption of Verizon's public service responsibilities will serve the public interest. To us, this means that the Commission should do more than satisfy itself that FairPoint can serve as a roughly equal replacement for Verizon under the premise that all of the key assumptions on which FairPoint has based its expectations and commitments will prove to be valid. The Commission should, considering the important and difficult-to-measure uncertainties, require that this acquisition demonstrate tangible and material offsetting benefits.

Q. Please place the risks that concern you in the context of FairPoint's experience and the prospects of continuing reductions in access lines in the northern New England region.

A. This transaction offers to New Hampshire businesses and residents a replacement provider of critical services who faces possible risks due to a shrinking revenue base and a financial structure that simply cannot hope to match that of the current incumbent. Liberty's analysis of the future of Verizon's northern New England operations under FairPoint's ownership (using FairPoint's financial model) evidenced a substantial risk that the Company will not be able to fund capital and operations requirements while maintaining the high dividend level that serves as a cornerstone of its approach for producing shareowner value. If FairPoint had previous experience running businesses with the size and scope of Verizon's northern New England operations, or if it was maintaining the same senior team, systems, and management teams as Verizon has used, we would place less emphasis on that risk.

Similarly, if the outlook for the local-exchange business were brighter, concern about the risks of that business and of FairPoint's ability to address them would be at least somewhat mitigated. A management team that has not run a business of this size and complexity may not increase the risks inherent in the local-exchange business. However, the learning curve that management must climb will bring stumbles that will make financial risks greater. That expectation and FairPoint's relative lack of due diligence about the network it will assume increase risk.

Summary of Operations and Financial Risks

Q. How do you categorize the operational risks that this transfer presents?

A. As addressed primarily in our operations testimony (submitted by Mr. Falcone and Mr. King), the operational risks fall into seven key areas:

1. Broadband Plans and Commitments
2. Other Network Issues
3. The Transitional Services Agreement (TSA) and Back-office System Integration
4. Staffing
5. Network Service Quality
6. Retail Service
7. Wholesale Service

Q. Does the proposed transfer present only added risks?

A. No, as the operational testimony observes, a number of positive aspects of the proposed transaction can bring benefits to New Hampshire, provided that FairPoint can successfully manage the transition while maintaining a healthy financial condition.

FairPoint has the potential to focus on addressing the needs of New Hampshire customers more narrowly than Verizon, which appears to have broader interests and concerns. FairPoint's management exhibits an apparent desire to provide good service and innovative products. However, considerable uncertainties about the ultimate success of the transaction require changes to mitigate the risks that the operations testimony addresses.

Q. Please summarize the position of the Liberty witnesses with respect to FairPoint's broadband plans and commitments.

A. If completed, FairPoint's plan would provide significant benefit to the residents and businesses in New Hampshire in a technologically sound manner. However, FairPoint's limited due diligence gives it insufficient knowledge of the state of Verizon's network. Our concern is that the result is likely to be a need for considerably greater capital investment than planned, or a delay or scale-back of those plans. Therefore, Verizon should be required to provide, at least three months prior to closing, the detailed information about the network and unfettered access to the network facilities in New Hampshire so that FairPoint can develop a complete and well-founded New Hampshire broadband plan. Then, at least one month prior to close, FairPoint must develop a more precise estimate of the capital expenditures necessary to meet its broadband target. Should this new plan cause FairPoint to expend greater than 50 percent more in capital than currently planned, Verizon should provide the incremental funds needed. Finally, the Commission should require FairPoint to attain certain specified levels of DSL availability at specified future dates after close, rather than using total amounts expended as a benchmark for measuring the sufficiency of its broadband deployment.

Q. Please summarize the Liberty team's other network-related concerns.

A. FairPoint's management team is appropriately concerned with addressing network issues necessary to provide good service, but its limited knowledge of the state of Verizon's network creates significant uncertainty about meeting operational commitments. Therefore, Verizon should be required to pay to the full cost of certain ongoing projects, even if they continue after closing. In addition, Verizon should be required to pay for any other unexpected capital expenditures for certain remediation work of past known problems for one year after closing. In addition, three months prior to close, FairPoint should provide the Commission updates on certain plans related to E-911 and for replacing certain network functions currently performed by Verizon.

Q. What is the Liberty team's position about TSA and back-office system development and integration?

A. Providing a smooth transition is a crucial operational issue in this transaction. The transition presents significant risk. A recent similar transition demonstrates the potential for severe service consequences, a loss of customers, and significant additional expense. In order to mitigate the potential for such harm in New Hampshire, the Commission should require an amended TSA, whose monthly service charges do not vary from month to month, which reflects Verizon's true cost to provide the services, and which allows segmentation of service groups that could be transitioned at separate times with an associated reduction in the monthly TSA costs. Furthermore, the Commission should review and approve FairPoint's test plan and the testing that FairPoint has performed on its new systems, processes, and personnel and to review and approve the test results before FairPoint be allowed to cutover from any of Verizon's TSA services.

Q. Please summarize the Liberty team's conclusions about staffing.

A. FairPoint is highly dependent on Verizon to transfer the vast majority of the experienced staffing needed to assure effective operations and a smooth transition for customers. This need poses risk because, among other reasons, a significant number of Verizon employees are retirement eligible and all have the ability to transfer to other positions within Verizon before closing if such positions become available.

FairPoint's needs to fill approximately 700 completely new positions before cutover, establish new work centers, and train all employees on the new back-office systems FairPoint has developed also impose risk. The need to concurrently manage these inter-related challenges poses formidable challenge for FairPoint. FairPoint should be required to provide monthly updates to the Commission beginning three months prior to close of the status of FairPoint's staffing plans and progress filling its open jobs, including the experience and training level both of these new employees and those transferred from Verizon. Verizon should also be required to make its employees available to help train the new FairPoint employees at FairPoint's request. The extent to which FairPoint has successfully staffed its operations and trained its employees should be a factor in the Commission's approval of cutover from the Verizon-provided TSA services to FairPoint's own systems and processes.

Q. Please summarize the views of Liberty's witnesses about network service quality.

A. FairPoint has acknowledged the Commission's long-standing concerns about service quality, but its insufficient knowledge of the New Hampshire network and the causes of the service performance problems place it in a poor position to determine what will prove necessary in resolving these concerns. The testimony of Robert Falcone and Charles King concludes that FairPoint is likely to be significantly underestimating the remediation that will be required to improve service quality.

The Commission should impose specific conditions related to service quality and service quality monitoring. FairPoint should complete a root-cause analysis of the service quality problems, and develop a remediation plan including the operational and capital costs of this remediation, in order to provide adequate assurances that it will meet service quality standards at a statewide and at a central office level by a certain date. Verizon should take responsibility for 50 percent of the capital costs FairPoint incurs to replace faulty existing plant facilities needed to bring service quality up to standards uncovered within 12 months after close.

Q. Please summarize the views of the Liberty witnesses about retail service.

A. The broadband, network, TSA, back-office systems, staffing, and network service quality issues already mentioned can adversely affect retail customers if not properly addressed. FairPoint should also be required to meet additional conditions to assure that they provide a seamless transition for retail customers, including maintenance of the same sales and options used by Verizon, assuring that customers are redirected to FairPoint using currently published telephone numbers, renegotiating contracts with payment agencies, producing a practical and comprehensive communications plan, reviewing the proposed billing format with the Commission, and assuring that call centers adhere to the Commission quality standards.

Q. Please summarize the views of the Liberty witnesses about wholesale service.

A. FairPoint has almost no experience providing service to wholesale customers. FairPoint must make the transition for its wholesale customers as smooth as possible, and maintain a stable operating environment for them. Achieving these goals requires that FairPoint meet certain conditions, including assuring the full applicability of the current Verizon Performance Assurance Plan to all relevant wholesale customers, committing to maintain the full range of current Verizon services for five years, committing to refrain from seeking any regulatory changes that would affect the provision of wholesale services for five years, and agreeing to involve wholesale customers in systems readiness testing.

Q. Please summarize the position of the Liberty witnesses on the financial aspects of the proposed transaction.

A. FairPoint's proposed financial structure is highly leveraged and its business model requires large dividend payouts. Success will require the Company to generate cash flow sufficient to cover interest expense of $160-$170 million per year, capital expenditures of $160-$170 million per year and dividends of $142 million per year. Inadequate cash flow poses a risk of failure to meet debt-agreement covenants that may lead to dividend cuts, mandatory prepayments of debt, and the potential loss of control of the company to lenders. The testimony of Robert Falcone and Charles King discusses management, staffing, transitional, operations, and other issues that add materially to concerns about the maintenance of adequate cash flow, both short and longer term. My testimony and that of Randall Vickroy addresses the prudence of relying on synergies to produce a significant, positive impact on cash flow. It also discusses the significant financial risk that a lengthened Transition Services Agreement term would produce. Importantly, his testimony assumes that certain additional risks (*e.g.*, higher then anticipated capital expenses for broadband expansion and other network infrastructure) will have been mitigated by measures proposed in the testimony of Robert Falcone and Charles King.

We conclude that there is too much uncertainty about FairPoint's ability to achieve its forecasted financial results. A failure to achieve the forecasted results pose a significant threat to ensuring the continued provision of reliable wireline service and desired new products.

Q. Please discuss specific aspects of those forecasts that you consider to be most significant.

FairPoint's financial forecasts project cash flow and financial results highly dependent on revenue and expense estimates for the wireline business. We found FairPoint's assumptions regarding the replacement of the back-office systems to be speculative. They are not based on experience with projects having either the nature or scope of those required. Recent experience with Hawaiian Telcom also show that there exists significant risk in bringing similar projects to full readiness in time to support cut-over. Similar implementation problems could cost FairPoint hundreds of millions of dollars and cause financial defaults, according to the sensitivity analysis performed by Mr. Vickroy. Assumptions about Transition Service Agreement length are also critical to FairPoint's financial results.

FairPoint's own analysis also demonstrates that its estimated synergy savings will prove critical to successful financial results. If all other assumptions are correct, but those savings do not occur, FairPoint's own analysis, which they call their MAC (material adverse change) analysis, would place FairPoint on the verge of financial covenant violations every year. In other words, there would be no margin left for any other contingency. One example of such an additional contingency would be the discovery, upon learning more about Verizon's network than FairPoint can currently know, that capital budgets for maintaining network infrastructure and for expanding broadband availability will need to be expanded. Others would include cost increases from system conversions, a longer TSA period than FairPoint assumes, and operating difficulties resulting from the organization and staffing changes and transitions that FairPoint must make concurrently, many of which the testimony of Mr. Falcone and Mr. King suggest are likely.

Q. How have Liberty's witnesses viewed the relevance of the Hawaiian Telcom experience to what we face here?

A. We do not predict that such results will occur here; however, we consider it a better model for a "worst case" scenario than the FairPoint MAC case, which merely eliminated what we already consider to be speculative synergies. Even the MAC case creates an unacceptably high potential for producing material debt covenant violations. A Hawaiian Telcom type scenario would result in covenant violations, the elimination of dividends, mandatory debt prepayments, and defaults scenarios. At the other end of the spectrum, only the most optimistic forecast presented by FairPoint produces successful financial results.

Q. What is the recommended approach for dealing with questions surrounding FairPoint's continued financial viability?

A. We propose to discuss with the applicants a set of financial conditions to be forged from the list set forth in Randall Vickroy's testimony. Those discussions will require taking account of the changes agreed to as a result of the recommendations of the testimony of Robert Falcone and Charles King. It will also be necessary to assure that the final financing agreements, which do not yet exist, contain provisions that are fully consistent with the conditions finally determined to be sufficient.

Q. Please summarize the position of the Liberty witnesses on the approval of the joint application as currently structured.

A. We believe that it should not be approved as structured. The risks that FairPoint will remain capable of continuing to provide safe, reliable, and economic service within a stable financial framework is too high as currently proposed. That said, we look forward to discussions in the ensuing weeks to craft a solution that will sufficiently mitigate those risks.

Governance

Q. What is your view of the governance structure proposed for FairPoint?

A. The overall board structure is generally appropriate. We have a concern, however, that it does not focus adequately on New Hampshire stakeholders. New Hampshire alone will represent between a quarter and a third of total FairPoint access lines following the acquisition. There is no provision requiring any advisory body or director representation from New Hampshire or even from the northern New England region. FairPoint is a relatively new publicly-traded corporation, having entered that status only in 2005. Its ability to craft a board that has substantial "local" representation is constrained by the power of Verizon to name up to six of the nine directors, according to the Direct Testimony of Walter E. Leach, Jr., March 23, 2007, page 18, lines 1-12.

Based on the nominations to date, the FairPoint board may have only one member with strong New Hampshire connections (see Verizon's response to Staff 5-1 and FairPoint's response to Staff FDR 5-4). This contrasts with Public Service of New

Hampshire, which serves the majority of the residents and businesses of New Hampshire. Its parent, Northeast Utilities, has ten outside directors, of whom two have strong New Hampshire connections.

Q. How does the size of FairPoint's post-acquisition New Hampshire operations compare with that of Northeast Utilities?

A. New Hampshire's approximately 600 thousand access lines will represent about 30 percent of FairPoint's total post-acquisition access lines, nationwide. PSNH's approximately 490,000 customers represent about 25 percent of Northeast Utilities' 1,890,000 electric customers.

Q. Has Verizon provided information about how it will identify the board candidates over which it has influence?

A. Yes; Verizon has said that it will select nominees who are not Verizon employees and that its nominees will have familiarity with the telecommunications business generally or possess other pertinent qualifications. Verizon has stated that it is "evaluating" the "independence" of nominees as determined under New York Stock Exchange standards (see Verizon's response to Staff 5-2.). Thus, we can assume, (if the merger agreement requirement is made a condition of acquisition approval) that the Verizon directors will not be employees. We have indications, but again no commitments, that these directors will: (a) have telecommunications experience, and (b) be independent of Verizon.

Q. Have the applicants made connections with northern New England a requirement for a minimum number of board members?

A. No.

Q. What else do we know about the composition of the board that will be responsible for the northern New England business?

A. The short answer is that we do not know much. We know the name and qualifications of only one new board nominee, Jane E. Newman (see Verizon's response to Staff 5-1 and FairPoint's response to Staff FDR 5-4). Her past memberships on the boards of directors of Verizon and Public Service of New Hampshire are encouraging, but we do not know if they will typify the qualifications of other prospective nominees and their ties to the region. FairPoint has not provided specific information on how it is choosing the qualifications for the remaining board seats. I also note that Verizon will name six of the nine directors of the new FairPoint. It is troublesome to see a party interested in departing the local exchange business retaining such strong control over the governance of FairPoint. We are further concerned about assuring that the new board focus more on the important new public service responsibilities the company will be undertaking than on the search for additional acquisitions.

Q. What do you propose with respect to the identification of post-acquisition board members?

A. We do not believe that the Commission should grant final approval of the transfer before FairPoint identifies all board candidates, provides their qualifications for review, and identifies the terms of individual members and their initial committee assignments. Moreover, we believe that the board should contain at least two members with strong ties to New Hampshire.

Q. Is there another method for assuring that overall governance and oversight have adequate New Hampshire input?

A. Yes; if there are no effective means to assure that the nominees to fill the new board seats will provide that input, the Commission could condition its approval of this transaction, (assuming it decides to grant it), on a commitment to create an advisory board composed of distinguished community and business leaders who will provide real advice and assistance to the FairPoint board of directors and senior management on the needs of its customers in this service territory.

Q. What is the committee structure of the proposed new FairPoint board of directors?

A. FairPoint anticipates continuing its current committee structure, at least as a minimum. That structure includes an Audit Committee, a Corporate Governance Committee, a Compensation Committee and an Executive Committee.

Q. Do you have any concerns about that structure?

A. Yes; we are concerned by the lack of a commitment to a Finance Committee. We believe that such a committee is particularly important given the financial risks involved in this transaction and the significant commitments and expectations with respect to capital improvements and service quality. It is important that such a committee be established and be filled with directors who have significant experience and qualifications in financing, capital requirements, capital and O&M budgeting, local-exchange governance or senior management, including in the northern New England region. The members should all be independent, with no more than one member at most having any significant historical or current business or financial ties to Verizon.

Q. Do you have any concerns about the powers granted to the Executive Committee of the FairPoint board of directors?

A. Yes; FairPoint's response to Staff Data Request 5-6 provided corporate governance and board guidelines. They permit the Executive Committee, between board meetings to exercise all of the powers of the full board, including the declaration of dividends. This provision is troublesome, particularly in the case of a new board that has not yet developed the experience required to make the assumption of its powers by a smaller group advisable. The Executive Committee's powers should be limited to emergencies in which there is a certification that it was not possible to arrange a full board meeting. In no case should the declaration of dividends be made at other than the full board level.

Management Issues

Q. Can you summarize what you consider to be particularly meaningful aspects of the "newness" of FairPoint's proposed management team?

A. I would start by noting that today's FairPoint operates less than one-fifth the access lines of Verizon's northern New England operations. A new senior management team, over 700 new support personnel, and a transferred (and presumably changed) population of approximately 3,000 Verizon employees must come together quickly and effectively to succeed in running a new operation that is more than five times greater, that faces significant and continuing customer and revenue loss, and that must find a way to improve service quality and extend broadband capability. We do not yet know what qualifications a number of key leaders will possess, including, for example, the Vice President of Operations and Engineering and two director-level managers in information technology. This team, once constituted, will have to manage the rapid build-up of a workforce of more than 700 to replace seasoned Verizon employees.

Q. What do you understand to be the status of FairPoint's efforts to assemble the management team that will lead its post-acquisition business in New Hampshire?

A. According to FairPoint's 2nd supplemental reply to Staff 2-61 and attachments FPNH 1097-1113, Mr. Nixon will serve as the president for northern New England operations, which will include the states of New Hampshire, Maine, and Vermont. There will be a separate COO for FairPoint's operations in other states. Each of these COOs will report directly to the FairPoint CEO. The other officers who report to the FairPoint CEO are three Executive Vice Presidents: Corporate Development, General Counsel, and Chief Financial Officer. (See also the Nixon Vermont rebuttal testimony, at page 4 and at pages 10 and 11.)

This structure means that all functions directly associated with the provision of service will fall under the direct authority of the northern New England region's COO, Mr. Nixon. Directly reporting to him will be Vice Presidents for : (1) Operations and Engineering, (2) Operations Staff, (3) Consumer and Small Business Sales and Service, (4) Business and Wholesale Services, (5) Regulatory and Government Affairs, (6) Information Services and Information Technology, (7) Human Resources, and (8) Marketing and Product Development. FairPoint will locate most of these vice presidents in northern New England.

The structure and locations of the executive team are generally appropriate; they provide for in-region control of key activities, limiting those outside the region to corporate support and administrative service areas typically located centrally in a multi-state utility business. Those officers already identified bring substantial experience in their areas of responsibility. Moreover, much of that experience has come in the telecommunications industry. We have examined many data request responses, talked with senior leadership on a number of occasions, and listened carefully to the observations they made at the technical conference on June 4-6. We find the team members already named to be well qualified and capable of managing the business long term. The existence of a transition services agreement with Verizon and the use of capable outside assistance in systems development will give them substantial support in their efforts to come up to speed in a timely manner.

Q. Has FairPoint identified any specific needs for additional experience that it considers significant?

A. Yes; FairPoint stated in response to Staff Data Request 5-18 that it is seeking "additional talent and experience in at least the following areas: centralized network monitoring and surveillance, large data center operations and development, wholesale service and operations and labor relations re: predominantly organized workforce."

Q. What has FairPoint said about its northern New England regulatory and human relations organizations?

A. FairPoint has said that it may be combined with the organization that currently exists for its other operations. It has also said that its single human resources organization will serve all of FairPoint.

Q. Do you have any concerns about the senior management team?

A. There are key vice presidential positions (operations and engineering, marketing and product management, and regulatory and governmental affairs) that remain open. It is important that FairPoint demonstrate before it secures this Commission's approval of the acquisition that those positions will be filled by experienced persons. We also believe that the size of northern New England operations calls for the assignment of in-region, senior legal resources to Mr. Nixon's staff, with a dotted-line reporting relationship to the home office general counsel, should FairPoint wish it. We further believe there needs to be more definition with respect to how New Hampshire regulatory matters will be handled.

Q. Do you have any concerns about the fact that a number of FairPoint officers and organizations will have responsibilities that extend to activities beyond those necessary solely for northern New England local exchange operations?

A. Yes; FairPoint has not clarified how it will address the potential for cross subsidization of other operations, development, or other activities by northern New England operations.

Q. Do you have any other concerns about FairPoint's overall staffing plans for its northern New England operations?

A. Yes; our concerns relate to the fact that FairPoint's senior management team in northern New England does not have a performance track record of working together at all, let alone in a business of the size and scope they will have to manage in northern New England. Mr. Nixon's rebuttal testimony in Vermont notes that he is working on key performance indicators, but has not yet developed them (see page 20 of his Vermont rebuttal testimony). That rebuttal testimony also observes that staffing plans are not yet completed (see page 22); nor have the individual performance and quality-of-service goals for each officer who reports directly to Mr. Nixon been developed (see page 23).

These management elements are important for all organizations; they have even greater significance for a newly assembled team and a company that will be operating at a vastly increased level. FairPoint should demonstrate the existence and adequacy of these elements prior to securing this Commission's approval of the acquisition.

Q. What level of specificity has FairPoint provided about the "benchmarks, metrics, or other measures expected to be used to measure the quality and economy of the expected corporate and administrative services provided specifically to support the New Hampshire operations" following the proposed acquisition?

A. FairPoint has provided very little with respect to the benchmarks, metrics and measures it will use to measure the performance of corporate and administrative support services. Staff Data Request 5-22 asked specifically for the information that this question quotes. Surprisingly, FairPoint objected to the question as vague, which raises a red flag as to the company's understanding of and commitment to the use of performance measurements. FairPoint went on to answer categorically in a way that was not helpful. FairPoint said that it will, "use a combination of service level objectives required by customer contracts and, as may be applicable, by regulatory agencies, along with key performance indicators and customer surveys now being developed to measure customer satisfaction." FairPoint's response lacked meaningful detail and the focus on contracts, regulatory agencies, and customer satisfaction does not address economy of corporate and administrative services at all.

Synergies

Q. Mr. Vickroy's testimony discusses financial concerns arising from the use of FairPoint's assumptions about synergies; what inquiry did Staff make into the basis for those assumptions?

A. We asked a number of data requests, which I will summarize. First, Staff Data Request 1-7 asked for synergies by various categories. FairPoint replied simply by stating that the synergies are the differences between FairPoint's incremental costs and Verizon's allocated costs. FairPoint then referred to the base case financial model attachments that estimated dollar amounts of those synergies. Second, Staff Data Request 1-97 raised the economies of scale issue. FairPoint avoided addressing the question. Third, Staff Data Requests 1-124 and 1-126 asked for details of the projected synergies. FairPoint replied by referring again to the base case model attachments. Fourth, Staff Data Request 1-136 asked for justification that the synergies would be realized by 2009. FairPoint did not provide a justification. We have also reviewed the very recently received FairPoint Confidential Attachment CFPNH 3008, which provided spreadsheets for calculating the synergies but no justification for the underlying assumptions.

Q. How reliable do you consider FairPoint's estimates of synergies to be?

A. We do not place significant reliance on the synergy estimates, as we have not seen any substantial analytical support for them. FairPoint has a vastly smaller base than Verizon across which to spread its costs, whether they consist of common administrative and general and governance and support costs, or whether they consist of the costs of technical operating, supervision, service, or other such groups. It is extremely atypical to find that a reduction in scope and scale will produce an increase in cost efficiency.

We certainly agree that it is reasonable to expect that certain costs of operating in more urban areas can be lowered on a gross unit-cost basis (*e.g.*, rental costs per square foot or personnel benefits per hour of productive labor*)*, but it is not reasonable, absent supporting analysis, to assume that those cost will be lower on a net basis; (*i.e*, total rental, wage and salary, or benefits costs ultimately assigned to each hour of productive labor.)

Q. What experience does Liberty have in examining synergies and efficiencies from combined services and activities?

A. Liberty has performed a large number of analyses of common costs in large utility organizations and has reviewed synergy savings analyses performed as part of a significant number of merger and acquisition proceedings. These engagements cover a wide range of telecommunications and energy companies operating in many regions of the country (including northern New England) and in a variety of corporate structures. They also include a range of different approaches to and levels of combined governance, executive management, corporate and administrative service, technical and operating functions, and information system services. Liberty's analyses also cover a time period of more than fifteen years.

Q. Please describe more specifically Liberty's prior experience in engagements that you believe are relevant?

A. Management and operations audits have provided a primary source of that experience. Liberty is a national leader in the performance of management and operations audits for public service commissions. Liberty has performed more than 20 of them at energy or telecommunications utilities for the utility regulatory bodies of Arkansas, Connecticut, Illinois, Kentucky, Maryland, New Hampshire, New Jersey, New York, Ohio, Pennsylvania, Tennessee, and Virginia.

Affiliate audits comprise a second source of that experience. Liberty has been performing affiliate transaction and relationship audits nearly continuously since beginning in this field more than ten years ago. Liberty has examined affiliate relations and transactions in some 30 different engagements, which it has performed for regulators in Arkansas, Connecticut, the District of Columbia, Hawaii, Illinois, Kentucky, Maryland, New Hampshire, New Jersey, New York, North Carolina, Pennsylvania, Tennessee, and Virginia.

Liberty's experience in affiliate audits includes work at some of the country's largest holding companies and utilities. In the telecommunications industry, they include Verizon and its predecessors GTE and NYNEX. In the energy industry, they include Duke Energy, Dominion Resources, AGLR, Northeast Utilities, First Energy, APS, Pepco, Consolidated Edison, and Public Service Enterprise Group. Liberty has worked at a number of other smaller holding companies as well. In the wake of the SBC/Ameritech combination, Liberty examined changes made in the performance of activities subject to the Public Utility Commission of Ohio's comprehensive retail service standards.

Liberty has also examined merger synergies either directly in connection with commission reviews of specific mergers, or in connection with actual achievement of projected savings. This experience has included work for the commissions of Arizona, New Hampshire, New Jersey, North Carolina, and Ohio.

Q. What general observations do you draw from Liberty's experience?

A. We have found large holding companies generally to be more efficient in the provision of common services than smaller utilities. In general, we have found substantial support for the commonly held notion that increasing the size and scope of company operations brings opportunity for greater efficiency and effectiveness, and that reduction of size and scope is far more likely to decrease, rather than increase efficiency and effectiveness.

There certainly are companies that pledge to lower expenses in the wake of a merger or acquisition. However, such synergies generally result from making operations larger, not smaller. Moreover, FairPoint is a company that: (a) seeks to take on a business far larger than it has experience in managing, (b) must create systems unlike those it has ever had occasion to use in its current business, and (c) must establish management and supervisory control over an entirely new senior management team and 700-strong work force. On top of these factors, all of which bear on expected levels of efficiency, FairPoint will inherit a population of 3,000 employees working now under a very different corporate culture. Recent increases in separation rates suggest that that the Verizon employee population is in a state of internal flux. Each of the efficiency-robbing factors I have listed can be expected to affect the new company well after the merger closing date.

To expect improvements in efficiency even with a sound analytical base would be extremely optimistic. To expect it on the basis of the kinds of information we have seen from FairPoint is unrealistic. It is sound for FairPoint to establish efficiency objectives and to try to meet them. What is not sound is to expect the Commission to take them as a supportable basis for examining the financial condition of FairPoint.

Yellow Pages Revenue

Q. How is yellow pages revenue currently treated for regulatory accounting purposes?

A. Based on Commission Order No. 24,345, Verizon imputes approximately $23.3 million per year in revenues derived from yellow page directories. The contribution from yellow pages in 2006 had the effect of increasing operating income by $13.9 million.

Q. What do you understand to be the positions of Verizon and FairPoint with respect to the post-acquisition continuation of that imputation?

A. Verizon's response to Staff Data Request 1-34, which referred specifically to directory margins, expressed the company's "understanding that FairPoint has agreed to be bound (on consummation of the transaction that is the subject of this proceeding) by all orders that are binding on Verizon New Hampshire, including Order No. 24,345, until or unless the Commission or a court of competent jurisdiction orders otherwise." At the technical conference, FairPoint did not endorse this view, suggesting that it did not anticipate a continuation of the imputation by FairPoint.

Q. What is your opinion of their views?

A. Verizon has a continuing regulatory obligation to impute the revenues. If Verizon were not selling its landline business, the obligation would remain; there is no sound basis to assert that a sale of the landline business terminates the imputation obligation. The failure of FairPoint to acknowledge the continuing regulatory obligation denies customers the benefit of the imputation without justification.

The obligation's principal significance now is in monitoring of the company's earnings. However, should there be a proceeding that addresses changes in New Hampshire retail rates, directory contribution (forgetting for the moment the correct way to measure it at the time of such a proceeding) would be relevant.

We presume that the parties have considered the value of all assets, liabilities, revenues, and costs in settling on a price for the transfer of the business. It would be surprising if they did not place on given components very different values than this Commission may apply in future rate proceedings. FairPoint can no more assign zero value for regulatory accounting purposes to this obligation than it can unilaterally apply its chosen values to any other assets, liabilities, revenues, or costs relevant to the provision of services that this Commission regulates.

Whether or not FairPoint properly understood the regulatory accounting for this or any other assets, liabilities, revenues, and costs has no bearing on how the Commission should treat directory contribution in light of this transaction. The simple and compelling conclusion is that it should continue to expect that contribution to be properly included in ongoing monitoring of the adequacy of currently established revenue requirements and to be properly included in any future proceedings addressing the reasonableness of rates – whether Verizon, FairPoint, or some other party is the local exchange provider.

Q. So far, you have put aside the question of valuing that contribution in the future; what observations do you have on that question?

A. With no sale of the business, a second phase of the Yellow Pages proceeding would have been necessary to quantify the prospective level of imputation. The initial valuation was made without solid data from Verizon about what the New Hampshire portion was contributing to the directory business. Verizon's affiliate was then operating the business on a regional, not a state-by-state basis. Therefore, the $23.3 million was an estimate of the amount to be imputed, made some years ago. Even more significant is the fact that Verizon's affiliate does not own the business at all anymore.

Q. Please summarizes the changes in the organizations that have published directories in New Hampshire.

A. Verizon's predecessors (before the AT&T divestiture) began directory publishing as part of the "Bell system." That role continued under NYNEX and Bell Atlantic after the creation of RBOCs. The 1997 NYNEX and Bell Atlantic merger led to combined directory operations. The later addition of GTE to the Verizon family of companies led to a further combination of directory operations in 2000, under a wholly owned Verizon subsidiary known as Verizon Directories Corp.

Verizon used a tax-free distribution of all its shares of Idearc common stock to Verizon's shareholders to spin-off the domestic print and Internet yellow pages directories publishing operations. This November 17, 2006 transition included a Verizon transfer to Idearc of its ownership interest in the subsidiary formerly known as Verizon Information Services Inc.

Q. What is Idearc's connection to Verizon's New Hampshire directories?

A. Idearc, a spin-off, rather than an affiliate of Verizon, has a 30-year agreement under which it serves as Verizon's exclusive, official publisher of print directories in the areas where Verizon is the incumbent local exchange carrier. Idearc uses the Verizon brand on print directories both in these Verizon markets (its "incumbent markets") and in its other markets where Verizon is not the incumbent (its "independent markets"). Idearc also continues an internet listings business that Verizon began in 1996. This business, Superpages.com, includes 18 million business listings and tens of millions of residential listings in the United States.

Q. What is the significance of print directories to Idearc's business?

A. Idearc's SEC Form 10-K for the 2006 calendar year discusses this issue in detail. See http://ir.idearc.com/secfiling.cfm?filingID=1193125-07-48926. This report states that Idearc derived about 93 percent of 2006 revenues from print directory advertising. The remainder came from its Internet businesses. Directory advertising was very profitable for Verizon and remains so for Idearc, generating 2006 revenues of $3.2 billion and operating income of $1.3 billion. Idearc has recently expressed the belief that it has an, "opportunity to increase the revenues from our independent print and Internet yellow pages directories businesses over the next several years."

Q. What is the connection between Idearc's print and electronic products?

A. Verizon launched what it calls Superpages.com in 1996. It encompasses about 18 million business listings and tens of millions of residential listings. Idearc considers Superpages.com to be "a natural extension of, and complement to" its print directories.

Q. How do the changes you have been discussing affect the question of the imputation at issue here?

A. The business of Idearc has not changed substantially. Print and electronic directory advertising still account for virtually all revenue and margin. Electronic advertising has increased, but print advertising still accounted for 91 percent of revenues in the first quarter of 2007 (http://ir.idearc.com/secfiling.cfm?filingID=1193125-07-110783. It is not, however, clear how association with FairPoint, as opposed to Verizon, will affect the business. It is also not clear that print advertising will remain so dominant or that Idearc will limit its business lines to those pursued by Verizon.

As a result, Idearc's directory margins are likely to become an increasingly less reliable proxy for those of Verizon as time passes. The $23.3 million would have become less reliable as a proxy for the contribution, even if Verizon had not spun out the business. Therefore, indefinite use of the $23.3 million annual figure will become increasingly more artificial over time.

Q. What would you propose as an alternative?

A. The successive dispositions of the directory business and then the New Hampshire land-line business should not be permitted to extinguish the benefit to customers from the Commission's determination in Order No. 24,345. The sale of Verizon NH cannot be found in the public interest without determining the proper regulatory treatment of directory revenues. Verizon made no provision for replacing the value of the imputation when it spun off the directory business to Idearc. Now Verizon proposes that the sale of its landline business would effectuate a transfer of the imputation responsibility as a regulatory liability to FairPoint, which will have no interest in the underlying revenues. FairPoint has not accepted that result. The lack of closure on an item of such significant customer value is not appropriate.

We are willing to discuss alternative ways to provide such closure, but consider it necessary to find an appropriate solution before Verizon NH transfers its assets. One option would be to provide some alternate, present form of compensation for customers in connection with the transfer, recognizing that there is no current impact on customers as long as FairPoint remains under current retail rates. That option might use the value of the relevant contribution measured at the time the directory assets were transferred to Idearc. It might also use the present value of the imputation. Another option would be for FairPoint to agree to continue the imputation. However, we consider those discussions premature in light of FairPoint's and Verizon's unwillingness to accept what we feel is a baseline requirement; *i.e.*, that acceptance of the continuing imputation requirement "comes with the territory" absent some acceptable means of liquidating its value, and providing it to customers.

Regional and Community Involvement

Q. Has FairPoint addressed specifically its economic development and corporate citizenship expectations?

A. Yes; but not in a way that has much substance. In response to Staff Data Request 5-12, FairPoint stated that it is developing specific economic development plans and generally intends to work collaboratively with the communities it serves. FairPoint offered a highly qualified statement of its other expectations related to corporate citizenship, stating, "To the extent possible, FairPoint will attempt to ensure continuity of charitable relationships with those established by Verizon."

Q. Has FairPoint made adequate representations about continuing the level of regional and community involvement that Verizon has demonstrated?

A. No; FairPoint has not made firm commitments about its role in economic development for New Hampshire, other than through its planned investment in telecommunications infrastructure and having employees live in the territory. FairPoint also has not made firm commitments about continuing the charitable relationships that Verizon has demonstrated.

Affiliate Relationships and Transactions

Q. Do you have any reason for concern about the extent of affiliate cost documentation that exists presently?

A. Yes; Staff Data Request 5-25 asked for a list of changes in the last three years "to the methods, formulas, or other policies and practices affecting the assignment and allocation of costs for organizations or groups that provide any services in common on a company-wide basis to FairPoint operating business units." FairPoint responded by stating that it, "complies with all applicable FCC and state commission rules regarding affiliate transactions and the allocation of costs. To the extent these rules have changed, FairPoint's procedures would have changed accordingly." Absent from the response was any citation to existing documentation. In response to another data request, Staff 1-21 FairPoint stated that it would adopt Verizon's cost allocation manual; *i.e.*, it again did not cite or rely on its own.

We believe that the cross-business unit application of multiple functions requires that FairPoint, prior to securing this Commission's approval of the acquisition, adopt and provide for review in this proceeding a detailed Cost Allocation Manual, service agreements, and affiliate transaction policies and procedures, all of which should provide for comprehensiveness and clarity with respect to the nature of dealings among and the assignment and allocation of costs among FairPoint's various entities and business units.

Q. Does that complete your testimony?

A. Yes, it does.