Labor Intervenors Statement No. 1

STATE OF VERMONT
PUBLIC SERVICE BOARD

Joint Petition of Verizon New England Inc.,	)	
d/b/a Verizon Vermont, Certain Affiliates	)	
thereof, and FairPoint Communications,	)	Docket No. 7270
Inc., for approval of an asset transfer,	)	
acquisition of control by merger and	)	
associated transactions	)	

Direct Testimony
of

RANDY BARBER

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

May 24, 2007

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I. Introduction

Q. Please state your name and business address.

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

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

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

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

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

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

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

II. Background

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

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

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

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

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

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

In addition, I have performed a wide range of analyses of private sector pension plans and public employee retirement systems across the country. These include investigations into factors associated with under-funding, integration of two or more benefit plans, efforts to improve the operations of benefit plans, evaluations of proposed investment and funding mechanisms, and proposals to convert defined benefit plans into defined contribution plans. A number of the activities mentioned above have taken the form of joint labor-management initiatives in which I served as the union expert, paired with one or more management experts. Some of these projects included work with AT&T, Lucent Technologies, and the League of Voluntary Hospitals and Nursing Homes (New York City and environs).

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

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

III. Summary

Q. How is your testimony organized?

A. My testimony is divided into two separate parts. The first is this Statement with accompanying Schedules (Labor Intervenors Statement 1), which is a public document. In this Statement, I will summarize my analysis and conclusions, but without disclosing any information that FairPoint and/or Verizon claim to be confidential. My second Statement with accompanying Schedules (Labor Intervenors Statement 2) is entirely confidential and contains the details of my analysis using information that the Applicants claim to be confidential.

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

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

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

Q. Have you been able to review all of the information you require?

A. No, I have not. Because of FairPoint's objection to providing certain financial documents (those that are part of its Hart Scott Rodino filing) when they were supposed to be produced, I have not yet been able to review those documents. I hope to receive them before my rebuttal testimony is filed, so that I can render a complete opinion about FairPoint's financial and operational assumptions. In addition, certain documents were provided in a redacted form, even under the terms of the Protective Agreement and Protective Order. While FairPoint or Verizon represent that some of the redactions simply mask information that is not relevant to this proceeding, other redactions block disclosure of data that is almost certainly directly relevant to my analysis (selective redactions of spreadsheets or of dollar amounts in other documents, for example). Also, both FairPoint and Verizon have declined to reply to certain information requests, citing third-party confidentiality, relevance or similar reasons.

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

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

- Press reports;
- FairPoint and Verizon filings with the Securities and Exchange Commission (some dating back to the late 1990s);
- Documents from various public utility regulatory agencies;
- Documents derived from on-line databases;
- Confidential and non-confidential pre-filed testimony from the Applicants;
- Confidential and non-confidential replies (and associated attachments) to information requests to the Applicants from various Intervenors.

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

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

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

A. Yes.

Q. Please summarize your opinion.

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

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

A. The fundamental issue is one of risk, and who bears it. While no one can foresee the future, FairPoint is urging the PSB and all Vermonters to rely on the company's ability to accurately project the future in ways that, if they prove incorrect, could have highly negative consequences.[1]

FairPoint is a very risky holding company, specializing in acquiring, operating, and selling telecommunications companies. Fundamental to its financial strategy is the utilization of "free cash flow," derived primarily from depreciation, to pay very high dividends. FairPoint is cannibalizing itself by continually paying out more in dividends than it earns. It generates the cash to do this from depreciation – taking money that should be reinvested in its networks and, instead, paying it out to stockholders as a dividend. In its short life as a public company, FairPoint's shareholder equity has declined by $57 million, or 21.4%, even though its net income was $60 million for the same period.[2] That is, in the last two years, FairPoint has paid dividends equal to nearly twice its level of net income.

[1] I address this issue at some length in my Confidential Statement.
[2] Schedule RB-8

I call this cannibalization because FairPoint is quite literally eating itself alive. FairPoint's strategy is extremely risky and can continue for only so long. In order to sustain FairPoint's approach to business, it must continually acquire new companies (often using its common stock whose value is artificially inflated by the high dividend) and use the depreciation-based cash flows from those new companies to provide the cash to support its high payments.

In other words, FairPoint's approach to business is to invest as little as possible in capital plant and siphon the rest of the cash out of the operating companies to support its extraordinarily high dividend payment. It is not sustainable to continually pay out more in dividends than the company earns in net income.

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

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

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

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

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

A. There's an old saying: "Watch what someone does, not what they say." FairPoint is making a lot of promises, all based on a series of assumptions. Among the most critical of these assumptions is that, initially, it can successfully eliminate eight to ten percent of NNE's operating expenses. FairPoint projects it will achieve $60 to $75 million in cost reductions by replacing expenses allocated to NNE by Verizon for "back office" and other network system services with some 600 newly created systems and functions.

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[3] As part of this transaction, Verizon paid FairPoint $55 million for FairPoint's interest in a cellular telephone partnership in New York. In addition, Verizon is paying $40 million of FairPoint's pre-closing transition costs.
[4] FairPoint response to Labor 1-49.

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

There is nothing in FairPoint's history that would lead us to believe that it can somehow magically reduce Verizon's expenses by $60 to $75 million. Indeed, FairPoint's existing operations have per-access-line operating costs that are much higher than the NNE properties' costs – on average $108 per access line (17.3%) more than Verizon's NNE average costs over the past five years.[5] As I discuss later, further analysis of FairPoint's history shows that its operating costs continue to increase at a rate faster than inflation. This stands in stark contrast to FairPoint's statements that not only can it reduce Verizon's costs initially, but that it can continue to decrease those costs in the future. This is simply not credible.

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

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

Moreover, even with FairPoint's faulty assumption about expense reductions, FairPoint's financial model "works" only if it continues to pay out substantially more in

[5] Schedule RB-3.

dividends than it earns in net income. Thus, if FairPoint and Verizon had been combined in 2006, FairPoint would have paid out $141 million in dividends, but the combined company would have earned just $37 million in net income.[6]

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

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

IV. The Proposed Transaction

Q. What is your understanding of the proposed transaction?

A. While there are multiple elements and steps, Verizon and FairPoint have agreed to a transaction that would result in the spin off to Verizon shareholders of Verizon's regulated wireline businesses and certain non-regulated businesses in Vermont, New Hampshire, and Maine (referred to as "Spinco")[7] and immediately following merger of Spinco into FairPoint. In exchange for the Spinco shares, FairPoint would issue new FairPoint shares to Spinco shareholders. After the transaction is consummated, Verizon shareholders would own approximately 60% of FairPoint, which the parties have valued

[6] Schedule RB-3.
[7] Throughout this Statement, I refer to Spinco, Northern New England properties or businesses, or NNE interchangeably.

at slightly more than $1 billion (based on the price of FairPoint's stock prior to the announcement of the proposed transaction). Verizon would receive approximately $1.7 billion in consideration, in the form of a special dividend from Spinco and newly issued Spinco debt. The special dividend of about $900 million would be in the amount of Verizon's tax basis in Spinco and would be funded by new Spinco borrowings immediately prior to the spin off. The new Spinco debt of about $800 million would be designed to be exchanged by Verizon for existing Verizon debt. The "new" FairPoint would thus absorb Spinco's assets and liabilities. The transaction has been designed to be tax-free to Verizon and its shareholders, with Verizon saving a reported $600 to $700 million in taxes.[8]

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

A. The proposed transaction appears to me to have several quite unusual elements and to have significant structural and execution risks. FairPoint is proposing to acquire business assets that, depending on how one measures it, are 3.2 to 6.1 times larger than it. The latter ratio compares the access lines that FairPoint is contributing (14%) and those that Verizon NNE is contributing (86%), and seems to me to be the most important metric, reflecting the actual relative size of the companies' operations.[9] This alone raises serious questions in my mind about the risks associated with the proposed transaction.

I am also very concerned about financial terms of the proposed deal, with NNE acquiring $1.7 billion in new debt (which will either be paid to Verizon in cash as a special dividend or issued to Verizon as new NNE/FairPoint long-term debt). Of even

[8] See Pre-Filed Direct Testimony of Verizon Vice President Stephen E. Smith, pp. 10, 16-17; also see Pre-Filed Direct Testimony, Michael J. Balhoff, pp. 12-13
[9] See Schedule RB-1

more concern, in my view, are the very aggressive cost-cutting "synergies" that are key to FairPoint's post-closing operating plan. Specifically, FairPoint is projecting that it would achieve an eight to ten percent ($60 to $75 million) reduction in operating expense within a year after closing. What makes these cost-savings assumptions even more aggressive, in my view, is that they were to come out of Verizon's $240 million in "back office" and network allocations to NNE.[10] This implied that FairPoint thinks it will be able to replace these functions and save between 25 and 31 percent in the process. If achieving this goal is critical to the success of FairPoint's plans, there are some real risks to NNE's constituents inherent in the deal.

Further, while Deutsche Bank has delivered a "fairness opinion" to FairPoint's Board of Directors, Deutsche Bank explicitly "expressed no view as to the reasonableness of these forecasts and projections, including the synergies, or the assumptions on which they were based."[11] This means that, from the perspective of evaluating FairPoint's model and the projections it produces, no confidence can be placed in the fact that FairPoint received a fairness opinion from one of its investment advisors.

Because of the structural and execution risks inherent in the transaction, it appears to me that employees, customers, communities, and Verizon and FairPoint shareholders would be subject to various potential risks that could be quite significant. There is structural risk, in my view, because of the relative size and complexity of the

[10] While FairPoint initially stated that it planned to save $60 to $75 million in synergies to be gained by replacing Verizon's allocations to NNE, FairPoint's subsequent April 3, 2007 SEC Form S-4 filing indicated that the back office allocations during 2006 had actually been $270 million, although the $60 to $75 million target remained unchanged.
[11] FairPoint SEC Form S-4, p. 52

FairPoint and NNE operations, and there is execution risk because FairPoint must implement its plan more-or-less flawlessly.

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

The risks associated with this transaction could result in potential and very significant negative consequences that would vary by constituency: employees could be subject to job loss, changes in the working environment, wage reductions, and the reduction or elimination of current or prospective benefits; customers could be subject to rate increases, service degradation, and limited service offerings resulting from reduced operating, maintenance and capital expenditures; communities could be subject to limits on future growth and the economic impact of rate increases and reduced jobs, wages and benefits; Verizon shareholders could be subject to reduced value of their holdings in the FairPoint shares that they would be issued (without their approval, I would add); and, FairPoint shareholders would also be subject to reduced value in their FairPoint holdings, and they would end up owning a company (FairPoint) that is very different from the one they bought.

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

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

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

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

V. Detailed Analysis Using Public Data

A. Introduction and Identification of Schedules

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

A. Yes, I have. I have reviewed virtually all documents that have been submitted to-date (and were not withheld from Labor Interveners' experts) and performed analyses of those that appeared most relevant to the financial aspects of the transaction.

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

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

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

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

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

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

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

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

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

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

FairPoint and Verizon sometimes refer to the combined FairPoint/NNE's "Debt/Equity," which compares the combined companies' projected debt with the projected total stock market value of the combined firms.[13] This is not the metric normally associated with debt-to-equity ratios. A debt-to-equity ratio is a measure of a firm's total long term debt to the shareholder equity on its balance sheet.[14] More importantly, the ratio that the Applicants advance is of no use in evaluating a company's capital structure. While share prices reflect investor confidence in a firm (or in FairPoint's case, the attractiveness of very high dividend yields), they cannot be used to measure the internal balance between borrowings and retained earnings plus contributed capital that is the basis of determining relative leverage.

[13] Leach, A.DPS:FP.2-26, who argues that "a 63%/37% debt/equity ratio is a very reasonable capital structure" using the debt to projected market value metric.
[14] "LT Debt to Equity is calculated as: Long Term Debt / Common Equity . . . LT Debt to Equity is a measure of a company's financial leverage, and indicates what proportion of equity and debt that the company is using to finance its assets." Thompson Financial, Via AOL; visited 5/15/07

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

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

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

Schedule RB-6 reports computations of the operating expense per access line (or unit cost) for FairPoint and Verizon NNE over the five-year period for which comparable data are available. The schedule then compares the difference in these costs for FairPoint and Verizon NNE, on a dollar and percentage basis. The results are compelling on a number of levels. FairPoint's absolute costs per access line are significantly higher than Verizon NNE's ($108 or 17.3% higher on average). While FairPoint's reported increase in per access line cost grew at a slightly slower rate than NNE (27.2% vs. 30.6% over the five year period), FairPoint's average cost in 2006 may be somewhat distorted by two factors: it added 13,200 access lines via three acquisitions during the second half of 2006, and FairPoint began including an undisclosed number of lines from its CLEC subsidiaries beginning with the quarter ending September 30, 2006. The new access lines added later in 2006 account for 6.3% of FairPoint's reported year-end total. Since these newly acquired lines' operating expenses were included for less than six months, the acquisitions artificially reduced FairPoint's reported operating expense per access line somewhat.

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

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

In addition, Schedule RB-6 lets us evaluate the growth trend in operating expenses, which is an additional challenge that FairPoint will confront. During the 2002-2006 period, FairPoint acquired five companies with about 33,000 access lines (in 2003, 2005 and 2006) but FairPoint's unit costs have continued to rise. FairPoint has not demonstrated an ability to drive down unit costs, or even hold their growth materially below the levels experienced by NNE. Based on FairPoint's historic performance, applied to NNE's 5-year operating expense trends, one would predict that the *imbedded* rate of increase for NNE's operating expense per access line would be largely unaffected. Put another way, it seems reasonable to conclude that FairPoint will inherit an annual NNE unit operating expense growth rate of about 6% to 7%. There is no reason to believe that FairPoint will be able to do for NNE something it has not been able to do for its own operations.

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

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

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

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

Schedule RB-9: FairPoint Net Income, Depreciation, Dividends and Capital Expenditures, 2002-2006

My analysis of FairPoint's business model reveals another source of potential risk for NNE and its constituents. FairPoint is focused first and foremost on *cash flows*. Of course, net income is important, but FairPoint appears to pay much more attention to free cash flow, which is net income plus depreciation less capital expenditures.[15] As I explain below, FairPoint relies on depreciation – which is a non-cash charge against income – to fund its high dividend level and, it would appear, its acquisitions. This is problematic since depreciation is an accounting convention that permits companies to fund the replacement of worn out or obsolete capital assets. However, FairPoint is using depreciation as a "bank" to fund dividends.[16]

Schedule RB-9 reflects FairPoint's net income, depreciation, dividends and capital expenditures for the five year period 2002-2006 and calculates certain ratios.[17] As can be seen, capital expenditures as a proportion of depreciation have declined by more than a quarter, from 84% in 2002 to 61% in 2006. In 2006, FairPoint's dividends were 71% higher than its capital expenditures and 78% higher than its net income. In other words, the value of FairPoint's asset base is shrinking – it is recovering more in depreciation expense than it is spending to replace (or upgrade) its capital plant. This schedule shows that FairPoint's approach to business is to invest as little as possible in capital plant and siphon the rest of the cash out of the operating companies to support its extraordinarily high dividend payment. It is not sustainable to continually pay out more in dividends than the company earns in net income.

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

[15] Many companies also include one-time or extraordinary items in measuring their free cash flow, but FairPoint routinely excludes these items, since its debt covenants permit various adjustments that FairPoint carries through to its supplemental measures such as free cash flow.
[16] Since money is fungible, it is not possible to track the exact usage of depreciation; it is also certainly possible that FairPoint uses, or plans to use, depreciation to repay some debt and provide an operating cushion.
[17] FairPoint only began to pay dividends to common equity subsequent to its early 2005 IPO.

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

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

B. FairPoint's Financial Capability

Q. You have summarized your overall opinion of FairPoint's financial capability. Please explain in detail how you reached this opinion.

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

Q. What do you conclude about FairPoint's financial capability to undertake this transaction and to operate the Verizon Vermont system in a reliable manner?

A. The nature of this transaction, combined with FairPoint's history and structure, raise serious questions about FairPoint's ability to successfully execute this transaction and implement the myriad of fault-intolerant processes that it requires. Fundamental to FairPoint's plan is the assumption that it can simultaneously replicate some 600 Verizon systems and squeeze some 8% to 10% out of NNE's operating expenses, all within a very short time-frame. I conclude that FairPoint has an extremely small margin of error. If it fails by even a modest margin to execute its plans, FairPoint will be subject to financial pressures that it may well not be able to withstand without taking actions that could have a negative impact on employees, customers, communities, and shareholders. The ramifications of such actions could, in turn, have a detrimental impact on FairPoint's operating and financial capabilities. As I discuss below, these risks are magnified by several factors, including FairPoint's relatively small size compared to the NNE businesses it proposes to acquire, the significant differences between FairPoint's existing business and the NNE operations, the transformation to FairPoint that this transaction will effect, and the nature of FairPoint's business model.

Q. You mentioned that FairPoint's plans include replicating some 600 existing Verizon systems. Without disclosing any allegedly confidential information, please explain how this informs your conclusion that FairPoint would lack the financial capability to reliably operate Verizon Vermont.

A. FairPoint's projections do not take into consideration such potential risks (copiously documented in FairPoint's S-4 filing with the Securities and Exchange Commission) as the negative impact of delays in closing the transaction, a longer-than-anticipated transition period (during which FairPoint will be required to pay Verizon substantial amounts for "back office" and other services), higher-than-anticipated costs associated with the replication of 600 Verizon systems, less-than-adequate performance of the replicated systems, and many more. FairPoint's financial projections assume essentially flawless execution of the integration. If everything does not go perfectly, it could cause significant financial harm to FairPoint.

FairPoint's Michael Haga, in his Pre-Filed Direct Testimony, pointed out the differences between previous transactions that FairPoint has executed and the proposed NNE deal: "[T]here are aspects of this acquisition that obviously make this transition different from others we have done, namely the size of the transaction, the need to migrate from existing Verizon systems, and the addition of a wholesale business serving CLECs and other wholesale customers."[18]

Mr. Haga, who is charged with a range of transition planning and cutover-related tasks, disclosed that the tasks that FairPoint must confront are larger and more complex than they first appeared. He indicated that the services that Verizon will provide under the TSA "only provides for services in support of regulated LEC activities. Services for unregulated or non-LEC activities including long distance, Internet service, and customer premises equipment sales must be provided, at closing, by FairPoint." In addition, he states that "Verizon is not providing some services that would be used by the LEC. Most notably among these are procurement and logistics for materials and supplies and sales

[18] Michael Haga, p. 4

operations systems used by the sales force calling on customers." He indicated that Capgemini will be responsible for building those systems as well.[19]

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

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

A. The NNE and FairPoint businesses are rural, to be sure, but their business models are very different. Beyond the obvious difference in size (and FairPoint's need to focus on widely scattered and extremely small subsidiaries), all of FairPoint's subsidiaries are "rate of return" carriers and receive 6% to 7% of their revenues from the Universal Service Fund. These are very different businesses than the vastly larger and integrated NNE operations. Moreover, it is neither reasonable nor useful to compare FairPoint's "broadband" penetration by its subsidized subsidiaries with Verizon's current level of deployment. Also, expectations for FairPoint's success in increasing NNE's deployment based on FairPoint's past experience may well be misplaced. FairPoint enjoys both operating subsidies and a guaranteed rate of return in its rural operating companies and Verizon does not.

[19] Ibid.

C. FairPoint's Focus on Dividends and Cash Flows

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

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

The testimony of FairPoint's two financial witnesses is replete with discussions of the importance of cash flows.[20] For example, FairPoint Executive Vice-President Walter Leach states: "Critical to the commitment FairPoint is making is the ability to generate cash flow in excess of amounts required to support the planned investment operations and other obligations."[21]

FairPoint expert witness Michael J. Balhoff, in response to a question about how policymakers should review this transaction from a financial point of view was clear: "In terms of the financial perspective, policymakers should consider whether FairPoint has the ability to generate realistic cash flows to meet its pledge to increase capital commitments and to fulfill its obligations to its employees."[22] He also argued that "in the unlikely event that the operating environment proves more negative than the company's modeling," FairPoint would have a number of options available to it. These options, he

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

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

[22] Balhoff, p. 13

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

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

A. Yes, that is precisely what FairPoint says. I believe that it is worth noting that some sort of revenue raising and cost cutting (almost certainly involving employee compensation or outsourcing, or both) would be what Mr. Balhoff expects FairPoint to do first. Then, "if the operations became distressed," Mr. Balhoff lists FairPoint's option to "scale capital expenditures" (that is, reduce capital spending) and, finally, "alter the company's dividend policy."[23] Note the order and priority in Mr. Balhoff's list. From this statement, and many other indications, it is clear that FairPoint management will consider almost any alternative to reduce costs before turning to its high dividend policy.

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

A. While it is obvious that a high dividend policy is designed to please shareholders, it plays a key role in FairPoint's long-range business strategy. For example, FairPoint Chairman and CEO Frank Johnson told a group of investment analysts on a conference call the day the transaction was announced: "And to everyone, I state clearly that these new revenue opportunities and enhanced operating efficiencies will improve our financial base and further enhance our acquisition platform."[24] FairPoint's SEC Form S-4 makes a similar

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[23] Balhoff, pp. 13-14
[24] FairPoint SEC Form 8-K, January 19, 2007

point: "The merger would improve the combined company's acquisition platform which should allow it to generate even more synergies from follow-on acquisitions."[25] FairPoint's Mr. Leach echoes: "FairPoint is and will continue to be a telephone acquisition and operating company. … After we have completed the merger and successfully converted all systems and processes to the FairPoint platform, and are assured our customer service operations are at acceptable levels, we will then consider future acquisitions, because increasing scale and scope is important to continuing to provide efficient services to our customers."[26]

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

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

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

[25] FairPoint SEC Form S-4, April 3, 2007, p. 49
[26] Leach, pp. 41

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

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

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

D. FairPoint's Size and Level of Experience

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

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

FairPoint attempts to explain its failed CLEC venture by stating that it was "an experiment in a new market… that proved to be ill-timed."[27] This is probably true. However, this was also the only time that FairPoint has attempted to develop a business on such a large scale. FairPoint made an enormous bet on a large-scale operation, losing hundreds of millions of dollars, and wiping out the company's net worth, and then some. Largely as a result of this failed venture, FairPoint's shareholder equity went from $64.4 million in 2000 to a negative $149.5 million in 2001, a negative swing of $213.9 million. The failed CLEC venture, in retrospect, seems to have dramatically undermined FairPoint's earlier growth trajectory (see Schedule RB-10).

The simple truth is that FairPoint's management was not able to manage the scope and complexity of the operation. Yet, this is FairPoint's only experience with any business venture that even begins to approach the size and complexity of the proposed transaction, and it failed miserably. Moreover, five of FairPoint's key officers – Eugene B. Johnson, Walter E. Leach, Jr., Shirley J. Linn, Lisa R. Hood, and Peter G. Nixon – held significant positions at FairPoint during at least part of this financial debacle.

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

E. The Risks of Verizon Divestitures

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

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

Carlyle Group created a subsidiary called Hawaiian Telcom to become the local telephone company. Hawaiian Telcom entered into a Transition Services Agreement (TSA) with Verizon for the continuation of certain Verizon functions for up to nine months after the closing of the sale "to provide Hawaiian Telcom with adequate time to establish new and independent back office support systems in the State. Additionally, Carlyle engaged the services of BearingPoint, Inc. to establish the new and independent back office support systems."[28] This deal is nearly identical in concept to FairPoint's proposed TSA with Verizon and CapGemini.

Unfortunately, Hawaiian Telcom experienced significant problems despite the TSA. In a November 2006 report, Moody's Investor Service reported that Hawaiian Telcom had not managed to develop the systems it needs to function as a stand-alone business, citing a "continuing delay in creating fully functioning back office systems [that in turn] is contributing to numerous operational problems (i.e., customer care, order

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

management, billing, and financial reporting) and distracting senior management."[29] Moody's downgraded Hawaiian Telcom's speculative grade liquidity from SGL-3 to SGL-4 meaning liquidity is so weak that the company must rely on external financing services stating "[t]he company's financial and operating profile could be permanently impaired if the systems issues are not resolved quickly." Standard and Poor's followed suit in March 2007 when it cut Hawaiian Telcom's rating one level to B-. Standard and Poor's stated that Hawaiian Telcom has a "highly leveraged financial profile" whose "profitability significantly lags its peers."[30]

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

The experience of Hawaiian Telcom and the TSA should act as a cautionary tale for regulators examining the proposed Verizon-FairPoint transaction. There are important similarities between the two transactions. In both transactions, Verizon sells its local exchange operations to a highly leveraged firm that lacks experience with an operation of this magnitude; the purchasers need to develop and integrate new operating and support systems; and each of the purchasers enter into a TSA with Verizon to ostensibly smooth the transition process. However, one difference between the two

[29] The Deal, Carlyle continues to stumble with Hawaiian Telecom acquisition: Carlyle's Hawaiian Disconnect, December 4, 2006.
[30] Bloomberg News Service, Standard and Poor's cuts Hawaiian Telcom to B- rating, March 30, 2007.

situations is that the Carlyle Group has major financial resources it can extend to Hawaiian Telcom if it so desires. FairPoint will not have access to such resources.

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

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

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

That will not be the case here. The proposed deal with FairPoint is so large (representing almost a 600% increase in FairPoint's size), and so unlike anything that FairPoint has done in the past, that FairPoint cannot integrate NNE into existing FairPoint systems. Instead, FairPoint has to develop hundreds of complex systems and operations from scratch in order to attempt to run the NNE operations.

F. Evaluating FairPoint's Execution Risk

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

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

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

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

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

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

Indeed, when the transaction was originally announced, FairPoint said that its synergy savings would be achieved, in the words of FairPoint Executive Vice President and Chief Financial Officer John Crowley, by eliminating "$60 million to $75 million in expected synergies and cost savings or approximately eight to ten percent of current operating expense."[31] According to Crowley, these savings will come primarily from about $240 million in allocations for "support and back-office operations" provided to

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

NNE by Verizon. These numbers were based on Verizon's 2005 results, but, just a few months later, FairPoint's SEC Form S-4 disclosed that these back-office charges had grown to $270 million, a 12.5% increase.

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

Q. Can you describe a credible "worst case" scenario, from a financial perspective.

A. Actually, I'll start with a "worst case" scenario described by FairPoint's Executive Vice-President, Walter Leach. In response to a question posed by the Labor Intervenors regarding any sensitivity analyses that FairPoint or its advisors may have performed to test the likelihood and impact of over- or under-achieving FairPoint's projected cost savings, Mr. Leach pointed to a confidential analysis produced by Lehman Bros. "which illustrates a worst case scenario and the resulting financial metrics if $67 million less cash flow occurred." While Mr. Leach doesn't specify which year the $67 million underperformance applied, it appears that this "worst case" number represents the point at which FairPoint's Board of Directors would abandon the transaction.[32]

[32] FairPoint: A.CWA/IBEW:FP.1-35b

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

A. No, I cannot provide a detailed description of the cost savings.[33] FairPoint has not provided any detailed information about how it developed its estimated level of savings. The most recent information we have from FairPoint is a response to a DPS information request where Mr. Leach provided several clarifications and updates regarding FairPoint's projected "synergies" and cost savings.[34] According to Mr. Leach's response, Verizon's allocations to NNE (excluding depreciation) were $241 million in 2005 and $262 million in 2006, fairly minor variances from previously reported numbers. However, he then states that "FairPoint forecasts the allocation amount to be approximately $222 million in 2007," a $40 million projected decline in 2007 over 2006 (while Verizon is still in control of NNE).

Continuing, Mr. Leach said that synergies are "essentially the difference between the allocated costs that go away upon the close and the incremental direct cost that FairPoint must incur post-close" Using the $222 million allocation as a starting point, Leach states that "we anticipate eliminating approximately $100 million of the $222

[33] One confidential FairPoint document contains a single page purporting to detail the 2008 cost savings that FairPoint projects that it will achieve. Obviously I cannot comment on the contents of this document in my public testimony, other than to say that the non-confidential FairPoint response referenced in this paragraph (A.DPS:FP.1-78) in some ways tracks the confidential document.
[34] FairPoint: A.DPS:FP.1-78

million allocated costs." This represents a 45% reduction from Verizon's projected 2007 allocations (which are already fifteen percent lower than 2006 levels).[35]

Mr. Leach noted that there are partially offsetting expenses to these savings in areas "such as Engineering & Operations and Finance & Accounting where we anticipate, among other things, additional personnel needs to replace the centralized functions that will no longer continue." He stated that these cost increases "are expected to total approximately $45 million." This means that the initial synergies and cost savings are approximately $55 million ($100 million reduction in Verizon NNE's costs, offset by a $45 million increase in FairPoint's costs). Nonetheless, Mr. Leach reasserts FairPoint's publicly projected cost savings, stating: "[T]he net of the eliminated costs and increased direct costs is expected to be approximately $60 to $75 million on a run-rate basis following the successful integration." Thus, FairPoint appears to be projecting that, after it implements its initial "synergies" and cost savings, it will continue to *reduce* operating costs. This certainly runs counter to the operating expense experience of both NNE and FairPoint during most of this decade.[36]

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

A. As I mentioned previously, if FairPoint's projections prove to be overly optimistic and its results materially suffer, it will be confronted with the need to adjust its cash flow by squeezing its employees' compensation, raising prices, permitting service to deteriorate, reducing investment, cutting dividends, or, more likely, a combination of these or other

[35] Mr. Leach says that among the costs that "go away" are software depreciation. He doesn't explain why there is still depreciation in the Verizon allocation number when he also stated that the figures he provided exclude depreciation.
[36] FairPoint: A.DPS:FP.1-78

actions. The impact of such actions is likely to severely affect Vermont's consumers, work force, and economy.

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

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

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

All of these examples identify potential risks to various FairPoint constituencies. It is likely, though, that some constituencies would be more severely impacted than others. It is my opinion that, if this transaction proceeds, the risks of the deal will be allocated, in declining order, to employees, customers, communities and the state, shareholders, and lenders.

VI. What's in it for FairPoint

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

A. Obviously, I can't speak for FairPoint, but I believe that their business model has stalled over the past half dozen years, as I've mentioned above and as is reflected in Schedule RB-10. Just looking at the numbers, it is pretty clear that FairPoint hasn't really recovered from the CLEC debacle. For an acquisition-driven company, it hadn't engaged in transactions that materially increased its size and scope since 2000. In some ways, one could look at the NNE acquisition as a bit of a "hail Mary." Of course, FairPoint has been abetted by Verizon, which needed a willing partner who had the very special attribute of being small. Verizon needed FairPoint to do this deal, and judging by the $40 million in pre-closing support and $55 million from the purchase of FairPoint's interest in the cellular partnership, Verizon was willing to go a good distance to get this deal done. Ultimately, this transaction could transform FairPoint or it could severely, even fatally, wound the firm. As I have pointed out in this Statement, there are large degrees of risk for everyone, and FairPoint and its shareholders are no exception.

VII. Recommended Board Action

Q. Based on your entire analysis of the proposed transaction, including your allegedly confidential analysis described in Labor Intervenors Statement 2 and Dr. Peres's

testimony about service quality (Labor Intervenors Statement 3), what do you recommend?

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

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

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

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

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

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

Q. If the Board rejects this deal, aren't there risks associated with Verizon's continued ownership of the Vermont operations?

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

Q. Earlier, you mentioned that the Board could establish "benchmarks" for a Verizon divestiture of its Vermont operations. What do you mean by that?

A. By "benchmarks" I mean that in addition to rejecting this transaction, the Board also may wish to put Verizon on notice about the types of requirements that would be expected of any proposed acquirer of Verizon Vermont.

Q. What types of benchmarks would you propose?

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

1. Adequate capitalization;

2. Adequate reserves;

3. Adequate infrastructure; and,

4. A demonstrated ability to absorb, integrate, and operate entities of comparable size and complexity to the entities the acquirer is proposing to acquire.

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

A. No, it does not. FairPoint fails on every reasonable measure of a competent successor to Verizon Vermont.

Q. Does this conclude your public direct testimony?

A. Yes, it does, based on the information that has been available to me as of approximately May 17, 2007. If I receive additional information after that date, in Vermont or the other states with parallel proceedings, some of my opinions and analyses may change. I anticipate that I will be able to address any additional information in my rebuttal testimony.

Schedule RB-1

Relative Contributions to the Post-Transaction New FairPoint

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

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

Comparative FairPoint 2006 Actual and Pro Forma Per Share Data

	For the Year Ended 31-Dec-06
FairPoint Actual	
Earnings per share from continuing operations	$0.88
Book value per share	$6.38
Cash dividends per share	$1.59
Pro Forma Combined Company	
Earnings per share from continuing operations	$0.42
Book value per share	$3.36
Cash dividends per share	$1.59

Source: FairPoint SEC Form S-4

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

	Dividends	Net Income	Excess of Dividends Over Net Income	Dividends as % of Net Income
	($millions)			%
Verizon (2006)	$4,719.0	$6,197.0	($1,478.0)	76%
FairPoint (2006)	$55.2	$31.1	$24.1	177%
Combined FairPoint-NNE, Pro Forma, 2006	$140.9	$37.0	$103.9	381%

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

Schedule RB-4

Comparative 2006 Debt-to-Equity Ratios

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

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

Schedule RB-5

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

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

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

Schedule RB-6

FairPoint vs. Verizon Operating Expenses per Access Line

FairPoint

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

Verizon Northern New England

	2002	2003	2004	2005	2006
Total Operating Expenses ($000)	$1,019,000	$1,096,000	$997,000	$1,078,000	$1,082,000
Access Lines [1]	1,852,884	1,780,978	1,696,353	1,608,120	1,506,644
Operating Expense per Access Line	$550	$615	$588	$670	$718
Year-Over-Year Change (%)		*11.9%*	*-4.5%*	*14.1%*	*7.1%*
Five-Year Change ($)					$168
Five-Year Change (%)					*30.6%*

Difference: FairPoint vs. Verizon NNE

	2002	2003	2004	2005	2006
Operating Expense per Access Line ($)	$102	$31	$161	$133	$111
Operating Expense per Access Line (%)	18.5%	5.1%	27.4%	19.9%	15.5%
Average Five-Year Difference ($)					$108
Average Five-Year Difference (%)					*17.3%*

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

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

NOTE: 5 year period for which comparable data is available

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

Schedule RB-7

FairPoint: Quarterly Change in Per Access Line Operating Expense, 1Q06-1Q07

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

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

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

Sources: FairPoint Communications Forms 10K and 8K

Schedule RB-8

Changes in FairPoint's Shareholder Equity Since Its 2005 IPO

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

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

Sources: FairPoint Communications Forms 10K and 8K

FairPoint Net Income, Depreciation, Dividends and Capital Expenditures, 2002-2006

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

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

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

Source: FairPoint SEC Form 10K, 2006

Schedule RB-10