The Proposed FairPoint Purchase of Verizon's Properties Would Place Consumers, Workers and Communities at Risk

Communications Workers of America and the International Brotherhood of Electrical Workers

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FairPoint, a small highly leveraged acquisition firm with a market value of $640 million, is attempting to get regulatory approval for its proposed $2.7 billion acquisition of Verizon's Maine-New Hampshire-Vermont operations. There are significant questions concerning FairPoint's financial and managerial capacity to successfully operate and fund a new company that is six times its size. Indeed, the sale poses significant risks to consumers, workers and the economic health of our communities. These risks overwhelm any supposed benefits from the deal.

FairPoint's Shaky Finances Pose Significant Concerns & Risks

- **Morgan Stanley raises concerns about FairPoint's finances.** A June 5, 2007 Morgan Stanley research report stated "FairPoint's newly released standalone forecasts paint a much more negative picture than we…had modeled for 2008 and we are lowering our estimates accordingly." Morgan Stanley specifically cited FairPoint's inability to generate enough cash to pay its 2008 dividend, and provided statistics indicating larger losses of access lines than FairPoint projects.

- **Verizon had to prop FairPoint up so that it could fund its transaction related costs.** Verizon agreed to fund most of FairPoint's pre-transaction costs by directly paying $40 million to FairPoint and funneling $55 million through Verizon Wireless's purchase of FairPoint's share of a Verizon Wireless subsidiary in New York.

- **High debt and high debt-to-equity-ratios.** FairPoint is adding $1.7 billion in new debt. The post-merger company will also be much weaker financially than Verizon. For example, a high debt-to-equity-ratio means that a company relies much more on debt. If the general economy weakens, the highly leveraged company may have problems. In 2006 the debt to equity ratio was 0.59 for Verizon and 2.70 for FairPoint. However, it was 7.81 pro forma for the combined FairPoint-Verizon NNE operations. While FairPoint argues that somehow this deal will make it stronger, the issue for Northern New England is *how much weaker it will make the Verizon operations in those states*.

- **Projected $60-$75 million expense savings are in doubt**. The entire deal revolves around FairPoint's ability to cut costs by $60-75 million, through a 25%-30% reduction in "back office" and network operating expenses. Yet FairPoint has not demonstrated an ability to drive down operating expenses in its own subsidiaries: its unit operating expenses are higher than NNE's and its unit costs are increasing at the same level as NNE's.

- **FairPoint is "cannibalizing" itself by paying out more in dividends than it earns.** FairPoint's dividend payments are higher than its capital expenditures (126% greater in 2005 and 171% greater in 2006) and higher than net income (122% greater in 2005 and 178% greater in 2006). FairPoint has committed to an additional $85 million in dividend payouts following the merger. This model is not sustainable. FairPoint's own investment advisor, Deutsche Bank, projected that through 2015, FairPoint would obtain $290 million in cumulative profits while paying out $1.1 billion in dividends – a ratio of $4 in dividends for every $1 in projected profits.

- **FairPoint undercuts capital expenditures by using depreciation to fund dividends.** FairPoint's capital expenditures as a proportion of depreciation have been decreasing – from 84% in 2002 to 61% in 2006. Deutsche Bank also projected that for 2008-15 FairPoint would garner $2.2 billion in depreciation-based cash flow while investing just $1.5 billion in capital expenditures. FairPoint would pocket over $700 million for other purposes such as sky-high dividends and perhaps, other highly leveraged acquisitions.

- **Reduction in Shareholder Value**. FairPoint's shareholder value has eroded by $57 million or 21% from March 30 2005 to March 30 2006. Deutsche Bank projected that shareholder value will be negative in 2013.

FairPoint's Operational and Managerial Capacity Is Inadequate

- **The mouse swallowing the cat**. If the transaction is approved, FairPoint management would have to deal with a 614% increase in access lines and a 333% increase in employees. Verizon's NNE operations are 26 times larger than the largest local exchange company owned by FairPoint.

- **FairPoint failed in its attempt to launch an operation that was much larger than any of its rural telephone companies.** In 1998 FairPoint launched a CLEC business that, though larger than any of its telephone companies, was much smaller than Verizon's NNE properties. By 2000, the CLEC business accounted for 20% of FairPoint's revenues and over half of its capital expenditures. By the time FairPoint decided to discontinue the CLEC operation just three years after it was launched, it had accumulated hundreds of millions of dollars in losses and laid-off at least 365 employees.

- **There is a significant risk that FairPoint will run into delays and cost overruns when it replaces Verizon's 600 operational, support and administrative systems**. FairPoint has to recreate all of the systems that Verizon uses to run its operations. Yet, the commercially available software for customer relationship systems (such as service order processing, billing adjustments, billing inquiry, etc.) is largely unproven. No large incumbent exchange has chosen to implement new CRS systems. Yet, FairPoint will take this risky step. CRS systems represent just a portion of the 600 systems FairPoint will replace. W. Curtiss Mills, a technology and systems integration expert hired by the Vermont Department of Public Service to assess the transaction, stated: "I am not aware of any projects similar in scope and magnitude where the new implementation of most or all operationally and business systems occurred simultaneously with the integration and conversion of over 1,500,000 new customers." It is apparent that this entire process will face significant risks of delays, cost overruns, service disruptions, customer complaints, cash flow interruptions, etc.

- **FairPoint ran into significant problems when it attempted to create and integrate one new billing system**. When FairPoint introduced a new billing system, it had serious problems with the vendor, resulting in significant increases in customer complaints. Yet, FairPoint will be confronted with dozens of new systems if the transaction is approved – not just one billing system.

- **Hawaii Telcom provides an example of what could go wrong with such transitions**. In 2005, Verizon engaged in a very similar transaction in Hawaii when it sold its 715,000 access lines to the Carlyle Group. Hawaii Telcom experienced significant transition issues that resulted in major financial and customer service problems. One difference between the two situations is that the Carlyle Group has major financial resources it can extend to Hawaii Telcom if it so desires. FairPoint will not have access to such resources.

FairPoint Has Refused to Make Any Commitment to Provide Truly High Speed Internet

High speed broadband is now an economic necessity enabling such activities as telemedicine, e-commerce and interactive distance learning. These benefits can only be realized fully with truly high-speed internet access. Speed Matters. However, Maine, New Hampshire and Vermont are woefully lacking in slow copper based technologies such as DSL, much less high-capacity fiber networks. Fiber networks enable speeds up to 100 megabits per second (mbps) while DSL typically enables just 1.5 to 3 mbps. The FairPoint transaction will not bring our states any closer to the high speeds needed to take full advantage of the telecommunications super highway.

- **FairPoint's DSL - slower speeds at higher prices.** FairPoint currently charges $44.95 for 1.5 megabits per second (mbps) download and 512 kilobits per second upload speeds (kbps) for its DSL service. Verizon charges $29.99 for 3 mbps downstream and 768 kpbs upstream for its DSL. Thus, FairPoint charges 50% more for ½ the speed. However, DSL is not enough. Verizon offers high speed FiOS fiber service to tens of thousands of its New Hampshire customers who can obtain 15 mbps downstream and 2 mbps upstream for $49.99 – 10 times the speed of FairPoint for just $5 more.

- **FairPoint has NOT made any commitments to deploy the fiber needed to enable truly high-speed internet access**. Verizon started building its high speed fiber network in Southern New Hampshire and only stopped once it became clear that Verizon was selling its NNE lines. Burlington Telco is selling high speed fiber access in Vermont. Yet, FairPoint has made no commitments to fiber based services.

FairPoint Will Be Limited in its Ability to Improve Service Quality

- **FairPoint has had service quality problems in Vermont and Maine**. In Vermont, FairPoint had the highest rate of complaints for six of the last seven years of any telephone company including Verizon. In Maine, FairPoint had the highest complaint rate, disconnect notices and billing problems in 2005 and 2006.

- **Verizon has had significant service quality problems in the three states**. Verizon provided poor performance in clearing out of service troubles within 24 hours in each of the three states. Verizon also had other service quality problems. For example, in Vermont Verizon's service deteriorated from 2001 to 2006 in the percentage out of service over 24 hours for residences and businesses; percentage calls not answered within 20 seconds residential; percentage installation commitments not met; and customer trouble report rate.

- **FairPoint's limited resources would be further strained because it would have to improve the service quality of both FairPoint and former Verizon operations.**

FairPoint Has Not Made Any Commitment to Increase Jobs Directly Related to Service Quality

FairPoint has stated that it will hire 600 new workers to deal with administrative and support functions. However, there are many job-related problems that FairPoint does not mention.

- **No commitment for any increase in jobs directly related to service quality such as installation, maintenance or direct customer contact work**.
- **FairPoint may face a jobs crisis.** Many pension eligible workers with decades of experience have stated that they are likely to retire if the deal is approved. Service quality will suffer since FairPoint will have to hire inexperienced workers.
- **There is considerable risk that FairPoint will outsource many jobs – call center jobs are especially at risk.**

Verizon May Have Chosen FairPoint for Tax Avoidance Purposes Rather than its Financial and Operational Capacity to Succeed

Verizon avoided up to $700 million in taxes by selecting FairPoint which was small enough to qualify the transaction as a tax-free Reverse Morris Trust (RMT) – a "loophole" in the tax code that allows businesses to reorganize and sell assets without having to pay taxes. Verizon chose to avoid taxes by selling to FairPoint rather than consider larger companies such as CenturyTel, Citizens or Embarq that have the capital and operational resources needed to successfully run the NNE operations though they are too large to qualify for the RMT.

The Bottom Line: The Risks Posed by the Sale to FairPoint Vastly Outweigh Any Supposed Benefits

FairPoint promises to increase capital expenditures; improve service quality; significantly expand broadband availability; provide wholesale services to Competitive Local Exchange Carriers seamlessly and without any changes in rates; create 600 additional jobs; and do it all right away at significantly less cost than one of the largest and most experienced telecom companies in the world. FairPoint assures us that all this can be done even as it significantly increases its debt and dividend commitments, while developing and implementing 600 new operational, administrative and support systems. FairPoint basically says to trust them – they can do it all and satisfy everyone. However, FairPoint has neither the resources nor the experience to do it all.

- **Consumers, workers and communities will bear the risks of this transaction.** Traditionally, when acquisition companies run into problems they cut capital expenditures, layoff workers and attempt to increase rates.

  Consumer Risks: higher rates and/or worse services.
  Worker Risks: lost jobs, benefits and job security.
  Community Risks: worse service quality, less ability to respond to emergencies, and less build out of the high speed Internet needed for development.

- **The FairPoint option could be much worse than the Verizon option.** While Verizon has had problems with service quality and build out – it at least has the deep pockets and vast operational resources needed to improve service, build out high speed infrastructure and sustain its NNE operations over the long term amid economic dips and natural emergencies. For example, Verizon can draw on thousands of workers in nearby states in case of a disaster. FairPoint has limited resources and no margin for error to sustain on-going operations much less address emergencies.