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 BRIEF OF COMMUNICATIONS WORKERS OF AMERICA AND INTERNATIONAL BROTHERHOOD OF ELECTRICAL WORKERS (LABOR INTERVENORS)

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I. Introduction and Summary of Argument

Verizon New England Inc. and its parent Verizon Communications Inc. (collectively "Verizon") are seeking permission to divest its landline and long distance telecommunications business in Vermont and the neighboring states of New Hampshire and Maine (collectively, "Northern New England" or "NNE"). In particular, Verizon proposes to spin off its NNE operations into a new, separate subsidiary (usually called "Spinco" in the filed documents).

Spinco would then be acquired (through a merger) by an existing, very small telecommunications holding company, FairPoint Communications Inc. (FairPoint) for approximately $2.7 billion in consideration. The consideration would be paid in a combination of cash (approximately $900 million), newly issued FairPoint bonds (approximately $800 million), and FairPoint common stock (54 million shares whose value fluctuates, but is estimated to be worth approximately $1 billion). FairPoint will need to borrow the entire $1.7 billion non-stock consideration that will be paid to Verizon.

Verizon would then exchange the approximately $800 million in FairPoint bonds for existing Verizon long-term debt, and transfer the FairPoint common stock to existing Verizon stockholders. As a result, current Verizon stockholders would end up owning approximately 60% of FairPoint's common stock.

The Communications Workers of America (CWA) and International Brotherhood of Electrical Workers (IBEW) (collectively, "Labor Intervenors") represent more than 70 percent of Verizon New England Inc.'s workforce in Northern New England (NNE), including Verizon Vermont. CWA and IBEW intervened in this proceeding, as well as the parallel proceedings in New Hampshire and Maine, to protect the interests of its members. Those interests include having an employer that has the financial resources, technical expertise, and corporate culture to provide high-quality service to customers, while ensuring the safety and reliability of its facilities.

Labor Intervenors discuss in Section II, below, that the Public Service Board (Board) is required to determine whether the proposed transaction serves the public good. In reaching that determination, the Board has held that it will evaluate fifteen criteria. Labor Intervenors understand that all fifteen criteria are not of equal importance. Labor Intervenors have focused their attention on three criteria that Labor Intervenors submit are the most important to this transaction: (a) whether FairPoint will be financially stable and sound (criterion 9); (b) whether FairPoint's proposed acquisition will result in service quality being adequate (criterion 5); and (c) whether the proposed transaction would result in adequate customer service (criterion 6).

Labor Intervenors retained an independent financial consultant, Randy Barber, to provide an objective analysis of FairPoint's financial fitness to own and operate Verizon's NNE operations. As explained in Section III, below, Mr. Barber conducted an extensive financial analysis and concluded that FairPoint does not have the financial resources to provide safe and reliable service to Vermont's consumers. FairPoint's own financial projections show the company's financial condition worsening each year, with FairPoint continually paying out two to three times as much in dividends to stockholders as it actually earns on its operations. In effect, FairPoint projects that it will cannibalize Verizon Vermont – using all of the earnings (and much more) generated by the business to pay dividends to stockholders, instead of reinvesting in Vermont's telecommunications infrastructure. Indeed, FairPoint is projecting a significant decrease from Verizon's level of capital investment.

Mr. Barber also concluded that even that dire outcome is the result of FairPoint making extremely optimistic projections. None of those unfounded projections is more glaring than

FairPoint's assumption that it will lose between 4 and 4.5 percent of its workforce each year beginning in 2009. That represents more than 140 people in the first year; more than 700 people within five years. In effect, within five years, FairPoint projects that it will have fewer employees than Verizon NNE has today – even though FairPoint is hiring at least 675 new people to provide network operations, call center, and other back office operations provided for Verizon NNE by Verizon affiliates in other states. But within five years, FairPoint assumes it will be able to provide extensive new network and customer service functions, maintain the physical network, and fulfill its myriad promises, with fewer people than Verizon NNE has today.

In Section IV, below, Labor Intervenors evaluate the impact of the proposed transaction on service quality. The testimony of Dr. Kenneth Peres, an economist in CWA's national office, demonstrates that FairPoint does not have a history that is consistent with providing high quality service to customers. Further, given Verizon's inability or unwillingness to meet minimum service quality standards (let alone provide the type of high quality service that consumers expect), FairPoint would need to focus on – and devote significant resources to – providing reliable service. But FairPoint's ability to achieve acceptable service quality performance will be impaired by a lack of adequate resources, the potential loss of experienced workers, and the significant risks posed by FairPoint's creation and implementation of dozens of new operational, support and administrative systems.

Given FairPoint's inability to meet these critically important standards of fitness, Labor Intervenors strongly recommend that the Board reject the proposed transaction, as explained in Section V.A. FairPoint simply is not a qualified purchaser of Verizon's NNE operations, including Verizon Vermont. The deficiencies with FairPoint are too pervasive to be cured through the Board's usual practice of imposing conditions. Conditions cannot make FairPoint financially viable. Conditions cannot give FairPoint the resources necessary to provide reliable service to customers. Conditions cannot fully protect the public against the likely adverse consequences of allowing FairPoint to own and operate Verizon Vermont.

In the event that the Board disagrees, however, Labor Intervenors recommend in Section V.B, below, that the Board adopt several, stringent conditions. Labor Intervenors would emphasize that these conditions would not make this transaction beneficial to the public, or even ensure that the public is not harmed by the transaction. Rather, even the most stringent conditions would only be an attempt to insulate the public from some of the serious risks posed by the proposed transaction. In Labor Intervenors' judgment, taken as a whole the conditions would not result in a transaction that promotes the public good. They would only lead to a transaction that is less harmful to the public than the transaction that would exist if the application were granted as proposed by FairPoint and Verizon.

Board Member Coen summarized the difficult decision the Board faces, when he asked Dr. Peres: "So FairPoint may have the desire to do this from your perspective but not the resources, and Verizon has the resources but not the desire. Would that summarize what you're saying?" Tr. 9/20/07 at 39. Dr. Peres explained as follows that the best way – indeed the only way – to deal with this apparent conundrum is to reject the proposed transaction:

> [I]f the Board denies the transaction, that sends a very significant message to Verizon at two levels. The first level is that if it still wants to sell these assets, these operations, that it would have to find a buyer that would actually have the requisite financial resources, the operational resources and capacity and the experience to serve what in our view is the public interest of the State of Vermont … . That message would be loud and clear so that they wouldn't focus on a firm that is much much smaller and not having the resources or the experience and capabilities. That would be one message.

> The other message would be that if Verizon is to continue in this state it would have to change its operating plan and focus more on service quality, and I would hope that the company would learn that lesson … .

Tr. 9/20/07 at 41-42.

Labor Intervenors conclude, therefore, that the best way, perhaps the only way, for the Board to protect the public is to reject the proposed transaction. FairPoint does not have the resources or expertise to step into Verizon's shoes. There is no set of conditions that would make this transaction consistent with the public good.

II. Legal Standards

The Vermont statutes prohibit the sale or merger of a controlling interest in a public utility (including a utility's parent company) without the Board's prior approval. Specifically, 30 V.S.A. § 107(a) states: "No company shall directly or indirectly acquire a controlling interest in any company subject to the jurisdiction of the public service board, or in any company which, directly or indirectly has a controlling interest in such a company, without the approval of the public service board." Section 107(e) defines a controlling interest as ten percent or more of the voting securities of a company.

In addition, the statutes require the Board to review any merger involving a Vermont public utility. Section 311 states: "A consolidation or merger under the provisions of this chapter shall not become effective without the approval of the public service board after due notice and opportunity for hearing." 30 V.S.A. § 311.

The Board has held that Section 311 refers to a merger involving either a public utility company or the parent company of a public utility. Docket 5900, Order of 2/26/97; Docket 6150, Order of 9/13/99.

There is no question that the Board must approve this transaction under both Sections 107 and 311. Verizon is proposing to transfer control of its Vermont public utility to FairPoint, by spinning off its operations into a new subsidiary (termed "Spinco" by the Applicants). Spinco will then be merged with and into FairPoint. After the transaction, Verizon's existing stockholders will own approximately 60 percent of FairPoint with approximately 40 percent being owned by existing stockholders of FairPoint. DPS Cross Exh. 19, p. F-66. As a result of these transactions – which would transfer approximately 40 percent of the ownership of Verizon's Vermont operations to new stockholders – there will be a statutory change in control of Verizon Vermont.

Moreover, because FairPoint currently owns public utility operations in Vermont, the transaction also constitutes a merger of two public utilities – bringing them under the same corporate parent – that must be reviewed under Section 311.

Finally, the transaction also constitutes a change in control of FairPoint's existing Vermont public utility, because 60 percent of the common stock of FairPoint will be transferred to new owners (current stockholders of Verizon).

The statutory standard for approving a change in control under Section 107 is that the transaction must promote the public good. The standard under Section 311 is that the transaction does not impair or obstruct competition in Vermont telecommunications markets.

The Board has put these broad standards into practice by establishing specific criteria that the Board will consider when evaluating a proposed transaction. If a transaction is only financial in nature (that is, it does not involve significant operational changes), the Board has held that it will evaluate the following five criteria:

1. Whether the new organization will be technically competent.
2. Whether the new organization will be financially sound.

3. Whether the new organization will act as a fair partner in business transactions with the citizens of Vermont.
4. Whether there are efficiencies that will benefit customers.
5. Whether the transaction will obstruct or impair competition.

Docket 6150, Order of 9/13/99; see also Order on Reconsideration of 11/5/99.

However, where the transaction is more fundamental, and includes a change in operations, key personnel, facilities, and significant changes, the Board will evaluate the following 15 criteria:

1. The company must have authorization from the FCC to provide the proposed services.
2. Emergency services must be available.
3. The system must be compatible with neighboring systems.
4. Terms and conditions of service must be just and reasonable.
5. Service quality will be adequate.
6. Customer service, including the processing of customer complaints, will be adequate.
7. The quality of facilities must be adequate.
8. The rate of investment will be adequate to provide the contemplated services.
9. The company must be financially stable and sound.
10. The company must take satisfactory steps to control affiliate interests.
11. Management must be competent.
12. The company must have the technical knowledge, experience and ability to provide the intended services.
13. The owner must have a good business reputation.
14. The merger should produce efficiencies in providing service.
15. The merger should not obstruct or impair competition.

Docket 6150, Order of 9/13/99; see also Order on Reconsideration of 11/5/99.

While the proposed transaction has serious financial implications, it is much more than a financial transaction. The proposed transaction would involve a series of fundamental changes in Verizon Vermont – new management, new network operations center, new customer service and repair centers, new billing and customer service systems, hundreds of new employees throughout Northern New England, among others. As the Board stated in its Order in Docket

6150, when describing the inter-relationship between the five criteria it announced in that case and the traditional 15 criteria it had applied in earlier cases:

> We conclude that the fifteen factors first listed in Docket 5900 should be applied under section 107 as considerations, rather than as independent criteria. Fundamentally, the statutory question is whether the merger will "promote the public good." While each of the fifteen items may be considered in reaching a decision, that decision, finally, consists of determining whether, based on the record, and balancing all of the factors, the public good standard is satisfied. While each of the fifteen factors continues to be relevant, none will, by itself, automatically be conclusive for or against an application.
>
> We also note that not all of the fifteen criteria are of equal importance. Some, such as obtaining FCC authority, may be subject to ready proof. Others, however, are of greater importance. When we consider under section 107 <u>whether a financial transaction</u> is in the public interest, we are primarily interested in five things: [list of five criteria followed].

Docket 6150, Order of 9/13/99 (emphasis added).

Throughout this proceeding, Labor Intervenors have focused on financial issues (criterion 9) and service quality issues (criteria 5 and 6), and that same focus is reflected in the remainder of this brief. That does not mean, however, that the other criteria are unimportant. Indeed, it appears that FairPoint's lack of experience with an operation the size of Verizon Vermont calls into question the quality of FairPoint's proposed facilities (criterion 7), the adequacy of FairPoint's proposed rate of investment (criterion 8), the relationship between Spinco's Vermont operations and other FairPoint companies (including the parent company) (criterion 10), the competence of FairPoint's management (criterion 11), FairPoint's technical capabilities (criterion 12), and FairPoint's ability to produce efficiencies (criterion 14).

Labor Intervenors respectfully urge the Board to review and analyze FairPoint's ability to meet each of the criteria used by the Board in evaluating transactions of this nature. Labor Intervenors submit that FairPoint is unable to meet several of these criteria – including the most critical one, financial stability and soundness. As a result, the Board must reject the proposed transaction.

III. FairPoint Will Not Be Financially Stable and Sound (Criterion 9)

A. Introduction

FairPoint prepared financial projections for the NNE operations through the year 2015. Even if all of FairPoint's assumptions were accepted, those projections show that FairPoint would not be financially stable and sound if this transaction is approved. Rather, as Labor Intervenors explain in Section III.B., those projections show a company that will be financially stressed and at serious risk of being unable to pay its common stock dividend, refinance its multi-billion dollar debt, meet its obligations to employees, and make the necessary investments in network maintenance and improvements.

Just as troubling is the fact that FairPoint's operating expense assumptions are seriously flawed. In Section III.C., Labor Intervenors discuss the grossly optimistic nature of FairPoint's expense assumptions. When those assumptions are made more realistic, it shows that FairPoint would be in financial distress within just a few years. Moreover that disastrous result would occur even if all of FairPoint's other assumptions – including its optimistic assumptions about revenues, DSL customers, reduced capital expenditure requirements, and more – are accepted.

In Section III.D., Labor Intervenors show that the financial analyses of other witnesses do not affect these conclusions. None of those witnesses could justify FairPoint's exceedingly optimistic assumptions about operating expense levels, including employee attrition. And none of them produced a financial analysis that results in FairPoint being a viable company with a bond rating that even approaches investment grade.

As a consequence, the Board must reject the proposed application, as explained in Section III.E. FairPoint is not a financially viable purchaser of Verizon's NNE operations, including Verizon Vermont. There is no set of conditions that would make FairPoint financially viable. While the Board could adopt conditions designed to protect consumers from some of the adverse consequences of financial failure, adopting such conditions would not make this transaction consistent with the public good. Rather, such conditions only would be an attempt to protect the public from some of the detrimental effects of FairPoint being allowed to own and operate Verizon Vermont.

B. FairPoint's Financial Projections Are Not Consistent with a Company that is Financially Stable and Sound

Even if the Board were to accept all of FairPoint's assumptions (which the Board certainly should not do, as explained in Section III.C, below), FairPoint's financial projections do not reflect a company that is financially stable and sound. Labor Intervenors' financial expert, Randy Barber[1], carefully reviewed FairPoint's projections and found them to be very disturbing.

Mr. Barber's review of FairPoint's history and method of doing business reveals a pattern that is troubling, to say the least. Mr. Barber's extensive testimony contains detailed analyses to support his conclusions. Rather than repeating all of that detail here, Labor Intervenors will focus on Mr. Barber's conclusions, which are fully supported by his testimony. Importantly, Mr. Barber concluded:

> 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. <u>FairPoint is cannibalizing itself by continually paying out more in dividends than it earns.</u> It generates the cash to do

[1] Mr. Barber has more than 25 years of experience as a financial analyst and occasional expert witness. His clients tend to be labor unions, and public and private pension funds. He has analyzed numerous transactions in several industries, including airlines, telecommunications, education, among others. Mr. Barber knows what it means for a company to be in financial distress, having worked on several bankruptcy proceedings, as well the divestiture of numerous Lucent Technologies lines of business. Labor St. 1 at 2-3. Mr. Barber's analyses of FairPoint can be found in his public direct testimony (Labor St. 1), highly confidential direct testimony (Labor St. 2), and his public and highly confidential surrebuttal testimony (Labor St. 1-R and Labor St. 2-R, respectively). Tr. 9/21/07 at 25A-4J.

> 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. That is, in the last two years, FairPoint has paid dividends equal to nearly twice its level of net income.
>
> 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.

Labor St. 1 at 6-7 (emphasis added).

Several of these points are worth emphasizing. FairPoint continually pays out far more in dividends than it earns in net income. For the past two years, FairPoint's level of dividend payments has been between 122% and 178% of net income. Labor Exh. RB-9. This is not sustainable and will soon result in FairPoint having negative shareholders' equity; that is, FairPoint's debt will exceed the book value of its assets.

Incredibly, FairPoint projects that this trend will be accelerated if it is allowed to purchase Verizon NNE. FairPoint projects that its dividend payments from 2009 through 2015 will range between 200% and 300% of net income. Labor Exh. RB-6R. The result is that its shareholders' equity will become negative by 2010 and will decline by hundreds of millions of dollars thereafter. FairPoint Exh. WL-2 (balance sheet).

Mr. Barber explained as follows that his focus was not just on the fact that shareholders' equity was negative, but on the direction and magnitude of the change:

> [M]y concern is less whether or not the absolute number in terms of shareholder equity is positive or negative, taken in isolation, [but on] … whether or not it is improving or it is declining.
>
> And what basically that measure represents is whether or not resources are being retained inside of the firm or being extracted from the firm. And the payment of dividends that are enormously higher than that income, for instance, that the firm earns, whether or not it can be sustained for some period of time by cash flow, is to me, less relevant, as whether or not resources are leaving the firm. … [O]ne of my main concerns looking at all of the projections I've seen from FairPoint, is … virtually every important measure in terms of cash flow is declining, and if you took it a straight line out one or two more years, it would not even be positive at that point.

Tr. 9/21/07 at 53-54 (emphasis added).

Mr. Barber used the term "cannibalization" to describe FairPoint's business model: the company is quite literally eating itself alive – extracting cash for stockholders well in excess of the equity those stockholders have invested in the firm and well in excess of the net income the business can earn. This led Mr. Barber to question whether FairPoint even would be able to call its payments to stockholders dividends and treat them as such for tax purposes. Labor St. 2 at 12. Mr. Barber's testimony on this point is based on counsel's legal analysis. Briefly, Section 170 of Delaware corporation law prohibits corporations from paying dividends that exceed the greater of the value of retained earnings or the net profit earned in the current year or the previous year.[2] 8 Del. C. § 170. Similarly, Sections 301 and 316 of the Internal Revenue Code

[2] FairPoint is a Delaware corporation. DPS Cross Exh. 19, opening letter. Interestingly, later in that S.E.C. filing, FairPoint recognizes this same concern, stating: "The combined company may not generate sufficient cash from continuing operations in the future, or have sufficient surplus or net profits under Delaware law, to pay dividends on its common stock in accordance with the dividend policy." Id., p. 35 (emphasis added).

limit the favorable income tax treatment for dividends to payments that are made from a corporation's accumulated net income. Payments in excess of that amount are treated as returns of capital which are taxed as capital gains. 26 U.S.C. §§ 301 and 316.

Simply, once FairPoint's retained earnings go negative (which under FairPoint's projection is in 2010), FairPoint legally would not be able to pay dividends in excess of its current year's net income. But that doesn't stop FairPoint. It projects that even after shareholders' equity becomes negative, it will continue to make payments to its stockholders that are at least twice as high as its level of net income. From 2010 through 2015, these excess payments total hundreds of millions of dollars. FairPoint Exh. WL-1. Those payments are not dividends; they represent FairPoint going deeper into debt, failing to reinvest in its NNE operations, or failing to reduce its outstanding debt – all to fulfill its corporate goal of enriching its stockholders.

Why is all this so troubling? It is troubling because the need in Vermont, Maine, and New Hampshire is great, but FairPoint's commitment is paltry. Rather than reduce its dividend payments to a level that can be supported by its earnings, FairPoint proposes to pay nearly all of its free cash flow to its stockholders. After the first year, its projected level of capital investment in NNE is substantially less than Verizon's current level of investment. Specifically, in 2006, Verizon NNE's capital expenditures were $214 million. DPS Cross Exh. 19, p. 16. During the past five years, Verizon NNE's capital expenditures have ranged between $182 million and $228 million. Id. In contrast, FairPoint is projecting capital expenditures from 2009 through 2015 of only $156 million to $167 million per year. Labor Exh. RB-1R.[3]

[3] See also DPS witness Wheaton's surrebuttal testimony, page 4, where he concluded that from 2003 to 2006 Verizon NNE's capital expenditures averaged $204.3 million per year, while FairPoint is projecting capital expenditures of just $143.4 per year from 2008 to 2012.

Instead of making excessive payments to stockholders, FairPoint could enhance service in NNE. But it has chosen not to. After the first year, FairPoint is projecting that its operating expenses and workforce levels will decline precipitously. Instead of making excessive payments to stockholders, FairPoint could make a strong commitment to NNE's economy and its quality of service by keeping its workforce at reasonable levels. But it has chosen not to.

The old saying is that if you want to see what's important to someone, don't listen to what they say, watch where they spend their money. FairPoint is spending its money on its stockholders – not on improving service to customers; not on capital expenditures; not on its workforce; and not on community development.

FairPoint will spend $50 million to $60 million <u>less</u> on capital expenditures <u>each year</u> than Verizon actually spent in 2006. That money would leave Northern New England and flow to FairPoint's stockholders.

Because of the extraordinary debt burden being undertaken by FairPoint for this transaction, it is unclear whether FairPoint would be able to significantly increase capital expenditures without being in default on its loans. FairPoint's commitment letter includes a restriction on the level of capital expenditures as a percentage of earnings. Labor Exh. 11. The percentage has not been established yet, but it is expected to be similar to (perhaps somewhat higher than) the existing loan agreement's restriction of 37.5% of adjusted EBITDA. Tr. 9/6/07 at 154-155. If that is the case, then FairPoint would be unable to increase capital expenditures even to the level that Verizon actually spent from 2002 through 2006. Tr. 9/18/07 at 88 and 114 (DPS witness Jeanson stating that his scenario where FairPoint's capital expenditures increased by $50 million annually would result in FairPoint violating the 37.5% limitation in every year). See also Tr. 9/5/07 at 167.

FairPoint also will reduce its workforce by between 100 and 150 people per year, "saving" tens of millions of dollars each year. Labor Exh. 12; Tr. 9/19/07 at 230-231. That money is leaving Northern New England and flowing to FairPoint's stockholders.

It could be argued that all of this might be acceptable so long as the utility is financially sound and stable. But that is not the case with FairPoint. FairPoint does not have an investment-grade bond rating and it does not have any prospects for obtaining, or desire to obtain, such a rating in the future. Tr. 9/5/07 at 31-34. Indeed, with shareholders' equity continuing to decline and dividend payments greatly in excess of earnings, it is difficult to see how FairPoint could ever obtain an investment-grade rating (unless, of course, it radically changed its priorities – which it has given no indication of doing).[4]

In fact, when FairPoint's Executive Vice President, Mr. Leach, was questioned by DPS counsel about the company's plans to obtain an investment-grade bond rating, Mr. Leach was quite candid in stating that FairPoint had no such plans. He made it clear that the company's objective was to provide the greatest return possible to stockholders, without regard to the risk that placed on customers, employees, or the public at large. Thus, he stated: "I think our objective is to manage the capital structure of the company, in the form that provides the greatest return to the shareholders." Tr. 9/5/07 at 32-33.

An investment-grade bond rating is not the only way for a utility to demonstrate its financial soundness and stability. A company could have a history of stable financial performance. Its financial metrics could show steady improvement. Reasonable assumptions could lead to projections of improved financial performance. But FairPoint has none of these.

[4] FairPoint witness King also acknowledged that FairPoint did not have an investment-grade rating due, at least in part, to its "aggressive capital structure" which he attributes to FairPoint's debt-to-equity ratio and its dividend policy. Tr. 9/6/07 at 185-186. DPS witness Wheaton also testified that if the Board is looking for an investment-grading bond rating, FairPoint "clearly … wouldn't meet that test." Tr. 9/21/07 at 88.

FairPoint came into existence in 1991. DPS Cross Exh. 19, p. 11. By 2002, it had lost hundreds of millions of dollars – resulting in shareholders' equity of negative $146 million. DPS Cross Exh. 19, p. 18. FairPoint continued to lose money in 2003 and 2004, so that by year-end 2004 shareholders' equity was negative $173 million. Id. In February 2005, FairPoint restructured financially, including an initial public offering (IPO) of common stock. Tr. 9/5/07 at 146, 150. The IPO and restructuring resulted in FairPoint restoring shareholders' equity to $267 million at March 31, 2005. Labor Exh. RB-8. But, once again, FairPoint's old ways intervened and it continued to pay out substantially more in dividends than it earned. Just ten months after the IPO (year-end 2005), FairPoint already had seen its shareholders' equity decline by $17 million. Id. And by March 31, 2007, FairPoint's shareholders' equity had declined by tens of millions of dollars to less than $210 million. Id. FairPoint is not a company with a history of stable financial performance.

Similarly, FairPoint's history is not consistent with a company that can improve its financial performance over time. In 2002, FairPoint lost $8 million on its continuing operations, before income taxes. DPS Cross Exh. 19, p. 17. It lost another $8 million in 2003, and the loss ballooned to $24 million in 2004. Id. As noted above, 2005 was a restructuring year that involved retiring debt and preferred stock and replacing much of it with common stock. In 2006, FairPoint showed positive income before taxes, but that was largely because it reduced its debt (resulting in lower interest expense) and substituted high-yield common stock. Thus, while FairPoint showed net income from continuing operations of $50 million in 2006, its shareholders' equity continued to decline because its dividend payments exceeded even its pre-tax net income by millions of dollars. Labor Exh. RB-9. FairPoint is not a company that has shown an ability to steadily improve its financial performance.

Finally, as discussed above, FairPoint's financial projections do not show stable financial performance going forward. FairPoint's projections – as optimistic as they are – show that the company's net income will increase slightly (but the increase is solely because of a decline in depreciation and amortization expense, due to FairPoint's under-investment in new plant). Labor Exh. RB-6R. FairPoint projects that its dividend payments will continue to greatly exceed its earnings. Id. The company projects that its capital expenditures will decline each year. Labor Exh. RB-1R. FairPoint projects that its shareholders' equity will steadily decline, go negative, and then continue to decline by hundreds of millions of dollars – all within the next eight years. FairPoint Exh. WL-2 (balance sheet). FairPoint is not a company that shows a reasonable likelihood of improved, or even stable, financial performance.

Based on his review of FairPoint's financial projections, history, and business model, Mr. Barber concluded that it would not serve the public good to permit FairPoint to consummate the proposed transaction. As Mr. Barber testified:

> 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.

Labor St. 1 at 40 (emphasis added).

In short, even under FairPoint's very optimistic projections, FairPoint is not financially stable and sound.

C. FairPoint's Operating Expense Assumptions are Fundamentally Flawed. If Those Assumptions are Made More Realistic, FairPoint Would be in Financial Distress.

FairPoint's projections for its operating expenses are seriously flawed, and those flaws are of such a magnitude that they call into question FairPoint's very financial solvency. That is, even if the Board accepts every other assumption FairPoint makes, correcting FairPoint's operating expense assumptions would be sufficient to find that FairPoint cannot be financially sound and stable.

Any analysis of FairPoint's operating expense projections should begin with a review of FairPoint's historic ability to predict and control operating expenses. Mr. Barber conducted such a review and found that FairPoint had not exhibited an ability either to accurately predict its operating expenses or to control the rate of growth in those expenses.

In April 2004, FairPoint prepared a projection of its operating expenses for the years 2005 and 2006. FairPoint projected that its operating expenses over that 20-month period would increase by 5.9%. In fact, FairPoint's expenses actually increased at nearly twice that rate, or by 10.7%. Labor St. 2 at 19; Labor Exh. RB-19.[5]

A miss of that magnitude – and over such a short period of time – certainly calls into question FairPoint's ability to project its operating expenses at all, let alone for an eight-year period.

Next, it would be reasonable to evaluate how well FairPoint and Verizon NNE have been able to control the growth in operating expenses over the past few years. After all, it's FairPoint's management and Verizon's operating personnel who will affect the growth in operating expenses going forward.

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[5] FairPoint's simultaneous projection of operating revenues was just as inaccurate, resulting in FairPoint missing its projected net income level by almost 20%. Labor St. 2 at 18-19; Labor Exh. RB-19.

Mr. Barber conducted that analysis and found that both FairPoint and Verizon NNE have experienced operating expense increases of about 5% or more per year. Specifically, over the five-year period from 2002 through 2006, FairPoint's operating expenses increased by $51 million (32%), even though its number of access lines increased by only about 10,000 (4%). Labor Exh. RB-6. The result is that FairPoint's operating expense per access line increased by more than 27% over this five-year period.

Mr. Barber's analysis of similar data for Verizon NNE shows that the number of access lines declined by 18%, but operating expenses still increased by more than 6% during this time period. On a per-line basis, the results are similar to FairPoint's: an increase of 30% over the five-year period. Labor Exh. RB-6.

In other words, both FairPoint and Verizon have a similar operating experience during the past five years: operating expenses per line are increasing at roughly 5% per year.

Inexplicably, FairPoint is projecting that its operating expenses per line, from 2009 through 2015, will be essentially flat, even after its assumed 8% to 12% reduction in operating expenses from "synergies." Labor Exh. RB-18. That is, despite FairPoint and Verizon NNE both experiencing growth in the range of 5% or more per year for the past five years, FairPoint somehow has assumed that it will magically turn this around, and operating expense growth will cease. Apparently, neither inflation, wage increases, supplier cost increases, nor any other factors will affect FairPoint between 2009 and 2015.

Further, on an overall basis, FairPoint has projected that its operating expenses will increase by less than 1% per year, and actually decrease in some years. FairPoint Exh. WL-2;

Labor Exh. RB-1R; Labor Exh. RB-5R. In fact, overall FairPoint projects that its cash operating expenses[6] will decline by 2% from 2009 through 2015. Tr. 9/6/07 at 35; Labor Exh. 10.

Incredibly, these projections are supposed to include the impact of eight years worth of inflation, wage increases, and other cost increases. Tr. 9/6/07 at 35.

This bears repeating: FairPoint projects that its actual, out of pocket cash expenses will be 2% lower in 2015 than they will be in 2009. Such a projection is simply not credible on its face.

FairPoint's expense projections would be laughable if the consequences were not so serious. And that seriousness is apparent when the details behind FairPoint's incredible projection are examined.

One of the fundamental flaws in FairPoint's projection is its assumption that it will lose between 4 and 4.5 percent of its workforce each year through attrition. Labor Exh. 12. With a starting workforce level of approximately 3,500 people (Tr. 9/19/07 at 230), FairPoint is effectively projecting the loss of between 140 and 155 people in 2009, with similar losses in each year following. Thus, within five years FairPoint projects that its workforce will be smaller than Verizon's NNE workforce is today, even though FairPoint has to hire at least 675 new people to perform functions currently performed by Verizon in states outside NNE. In effect, the equivalent of those 675 new employees would be gone within five years. Once again, such an assumption is simply not credible.

But the impact of just that employee attrition assumption is enormous – amounting to tens of millions of dollars per year (particularly in the later years of FairPoint's projection). See Tr. 9/6/07 at 13-20. Changing that assumption – and nothing else – would be sufficient to

[6] Operating expenses less depreciation and amortization, less the non-cash portion of pension and OPEB expense.

fundamentally change FairPoint's financial outlook. The magnitude of the change (the precise number is claimed by FairPoint to be confidential) would be roughly equivalent to FairPoint's projected net income in the later years, and would greatly exceed FairPoint's projected free cash flow after dividends in those years. Compare Tr. 9/6/07 at 13-20 with FairPoint Exh. WL-2.

FairPoint attempts to justify its attrition assumption based on the level of attrition that Verizon NNE actually experienced during 2006. Tr. 9/6/07 at 27. But such a comparison is flawed for at least two reasons.

First, there is no showing that what Verizon NNE experienced in one year will be replicated – or is even sustainable – over a seven- or eight-year period.

Second, it must be recalled that Verizon NNE is essentially just an operating utility. If FairPoint takes over the operation, it projects that it will add 675 new employees to perform functions that Verizon currently performs in states outside of NNE. These functions include network operations; various call center, customer service, and operator service functions; billing; administration; and many others. There has been no showing that Verizon experiences anywhere near the same level of attrition in those functions that it experiences within the NNE operation itself.

Thus, there is no basis for assuming that the attrition level that Verizon experienced in one year would provide a reasonable basis for FairPoint's assumption for the better part of a decade. Indeed, it would be hard to imagine that FairPoint would be able to provide even marginally acceptable service with a workforce that would shrink by roughly 900 people (a loss of about one in every four employees) in just seven or eight years.

But that is the leap of faith that is required in order to accept FairPoint's financial projections. One must assume that a company that has experienced 5% annual growth in expenses will acquire another company that has experienced 5% annual growth in expenses – and that magically we will have a company that experiences no growth in expenses. FairPoint will accomplish this miracle, apparently, by greatly reducing the size of its workforce. But don't worry, FairPoint assures us, it will be able to do much more with less – it will provide enhanced service to customers, a more reliable network, increased access to broadband services, and so much more. All with fewer people, lower expenses, and more efficiency than one of the largest telecommunications companies in the world.[7]

Were people's livelihoods not on the line, it would be a good joke. Were the future of Vermont's economy not in jeopardy, we would laugh out loud. It sounds like a good old-fashioned snake oil salesman, or what we learned in law school was called "dealer's puffing" – you can't rely on the promises made by a salesman when he touts his product because everyone knows he's just trying to make himself and his product look good.[8]

But this is no joke, we're not buying a used car, and the consequences of a mistake are dire. In fact, FairPoint itself has characterized a downturn in cash flow on the order of $67 million as being a "materially adverse condition" or "worst case" under which FairPoint's Board of Directors might abandon the transaction. Labor St. 1 at 35. <u>This is of the same order of magnitude as the impact of FairPoint's attrition assumption in 2015.</u> Tr. 9/6/07 at 13-20. In other words, even FairPoint recognizes that it cannot be financially solvent unless it reduces its workforce by more than 100 people each and every year.

In summary, FairPoint's operating expense assumptions – and particularly its employee attrition assumption – are seriously flawed and undercut its entire financial model. If a

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[7] As shown in the next section, FairPoint's projections are not made reasonable by assuming a loss of access lines.

[8] See generally 77 C.J.S. Sales § 310c ("Under the established and governing rules, dealer's talk is permissible; and puffing, or praise of the goods by the seller, is no warranty, such representations falling within the maxim *simplex commendatio non obligat*.")

reasonable level of expense increases over time, and a reasonable workforce level, were used, it would demonstrate unequivocally that FairPoint would be in serious financial distress. FairPoint simply does not have the financial capability to own and operate Verizon NNE.

D. The Analyses of FairPoint Witnesses Balhoff and King Do Not Alter These Conclusions

FairPoint hired two witnesses, Messrs. Balhoff and King, to review various aspects of FairPoint's projections. Both witnesses found that FairPoint's overall numbers were consistent with industry trends and similar to other medium-sized telephone operating companies. In both cases, though, the witnesses failed to review in detail FairPoint's assumptions for operating expenses, particularly the assumed loss of hundreds of employees. Indeed, Mr. Balhoff explicitly testified that while he reviewed some aspects of FairPoint's financial model, he did not review the workforce or attrition assumptions. Tr. 9/7/07 at 101-102.

Interestingly, though, while Mr. King did not present any comparative analysis of workforce levels, his exhibits provide the information to conduct such an analysis. Those data (FairPoint Exh. WEK-1, Table 1.1) show that Mr. King's "guideline" companies have a ratio of access lines to employees of between 208 (Consolidated Communications) and 405 (Windstream), with most companies falling in the middle of that range. Indeed, even the largest telecommunications companies in the country, Verizon and AT&T, only try to serve on the order of 200 access lines per employee.[9]

Yet FairPoint's projections for NNE start with it trying to serve an unprecedented 450 access lines per employee – more lines per employee than any other telecommunications company in the United States. Tr. 9/20/07 at 201-202; Tr. 9/21/07 at 7-8. And that ratio would only get worse under FairPoint's assumptions. From 2009 through 2015, FairPoint projects that

[9] All of these figures are calculated from Table 1.1 by dividing the number of access lines (times 1,000) by the number of employees. All figures are as of December 31, 2006.

it will lose employees at a higher rate than it will lose access lines. Compare Labor Exh. 12 (workforce reduction of 4 to 4.5% per year) with FairPoint Exh. WL-2, p. 1 of 10 (annual percent change in access line equivalents).

Moreover, Mr. King's analysis of data for comparably sized companies from the years 2004 through 2006, plus the first quarter of 2007, does not support the reasonableness of FairPoint's operating expense assumptions. In fact, Mr. King's analysis shows that FairPoint's operating expense assumptions (per line or per connection) for 2009 through 2015 are lower than its peers actually experienced between 2004 and early 2007. Labor St. 1-R at 11-12. Further, his comparison does not adjust the industry numbers for inflation, wage increases, energy prices, materials costs, or any other factors. Tr. 9/6/07 at 206.

Thus, rather than showing the reasonableness of FairPoint's projections, Mr. King's analysis actually shows that FairPoint is projecting operating expenses per line or per connection for 2009 through 2015 that are <u>lower</u> than its peers actually experienced historically. When coupled with FairPoint's projection that it will operate with far fewer employees per access line than other telecommunications companies, Mr. King's data and analysis actually reinforce Mr. Barber's finding that FairPoint's operating expense projections are unreasonable and incredibly optimistic.

E. Conclusion

FairPoint is financing the transition entirely with high-yield debt and high-yield common stock. The resulting interest and dividend payments not only leave little margin for error, they do not even leave enough room for reasonable operating assumptions. FairPoint's financial model is based on one fiction after another: FairPoint will be able to provide improved service while slashing the workforce by hundreds of people; FairPoint will be immune to inflation and so will be able to control expenses to an unprecedented level; FairPoint will be able to improve service and enhance broadband availability while spending $50 million to $60 million less per year on capital expenditures than Verizon has during the past five years.

There is no basis for such wishful thinking. In reality, FairPoint will be severely stressed financially. FairPoint's expenses will be higher than it projects; its earnings will be lower; its level of capital expenditures will need to be higher (but FairPoint's debt covenants may restrict its ability to actually increase capital expenditures to the level required).

Based on these facts, the Board must conclude that FairPoint is not financially fit to own and operate Verizon NNE, including Verizon Vermont.

IV. There is a Substantial Risk that FairPoint's Service Quality and Customer Service Will Not Be Adequate (Criteria 5 and 6)

A. Introduction

Service quality for Verizon Vermont's landline customers today is below acceptable levels. If FairPoint is permitted to own Verizon Vermont, it will put service quality in Vermont at additional risk. If the transaction is approved, FairPoint's ability to achieve acceptable service quality performance will be impaired by a lack of adequate resources, the potential loss of experienced workers, and the significant risks posed by FairPoint's creation and implementation of dozens of new operational, support and administrative systems. See Sections IV.B. and IV.C.

In fact, as discussed in Section IV.D., FairPoint itself has demonstrated the risks associated with the transition through its past poor performance, including problems its customers experienced when it attempted to develop new systems and run "new" businesses.

In Section IV.E., Labor Intervenors show that FairPoint's own track record in Vermont does not provide a basis for concluding FairPoint has a corporate commitment to high quality service.

As explained in Section IV.F., even if FairPoint were to promise the Board that it will bring service quality in the Verizon territory up to acceptable levels, in reality FairPoint will have fewer resources to improve service quality than Verizon and, therefore consumers will be in a worse position if the transaction is approved.

Based on FairPoint's history of mediocre service quality performance, as well as its severely constrained financial resources, the Board must conclude that FairPoint will not be able to provide adequate and reliable service to Vermont consumers. The Board, therefore, should reject the transaction. See Section IV.G.

If the Board disagrees, however, Labor Intervenors provide a list of service quality conditions in Section IV.H. These conditions would help to protect consumers from the adverse consequences of FairPoint ownership of Verizon Vermont, but they would not completely alleviate the harm to the public that would be caused if the transaction is approved.

B. If this Transaction is Approved, FairPoint Will Have to Expend Resources to Correct Service Quality Deficits Created by Verizon

If Verizon is allowed to transfer its landlines in Vermont to FairPoint, FairPoint will have to correct problems left behind by Verizon, in addition to fulfilling ongoing responsibilities to maintain service quality and customer service. Verizon has allowed service quality to deteriorate over the last several years. Only additional infusions of capital and personnel will permit FairPoint to remedy the service quality deficiencies accrued under Verizon's recent stewardship.

Dr. Kenneth Peres[10] showed that, from 2001 to 2006, Verizon experienced a 139% increase in residential and business complaints per 1 million access lines, a 50% increase in

[10] Dr. Peres is an economist in the national office of CWA. Among his other areas of expertise, he has testified on telephone utility service quality issues before several state utility commissions and the Federal Communications Commission. Labor St. 3 at 1-2. Dr. Peres's analysis of Verizon's and FairPoint's service quality can be found in his direct and surrebuttal testimonies (Labor Sts. 3 and 3-R, respectively; Tr. 9/20/07 at 8A-X and 8Y-BBB, respectively).

average installation intervals, a 47% increase in average out-of-service repair intervals, and a 35% increase in repeat out-of-service trouble reports as a percentage of initial out-of-service reports. Labor St. 3 at 12; Labor St. 3-R at 21. Complaints per one million lines in Vermont went from 342 in 2001 to just under 1000 in 2006. Labor St. 3 at 12. Similarly, average installation intervals in days lengthened from one day in 2001 to 1.5 days in 2006. Id. The out-of-service repair interval lengthened from 16.9 hours in 2001 to 24.9 hours in 2006. Finally, repeat troubles as a percent of initial out of service troubles increased from 12.4% in 2001 to 16.7% in 2006. Id.

Dr. Peres' observations that Verizon service quality has deteriorated in recent years are consistent with data gathered by the Vermont Department of Public Service. Based on this data, Dr. Peres showed that from 2001 to 2006, Verizon experienced an 87% increase in the percentage of residential out-of-service conditions not cleared within 24 hours, a 54% increase in the percentage of business out-of-service conditions not cleared within 24 hours, a 26% increase in the percentage of calls not answered by the company within 20 seconds, and a 75% increase in the percentage of missed installation appointments. Labor St. 3 at 13.

Similarly, Tamera Pariseau, testifying on behalf of the Department, described a number of service quality deficiencies, as well as problems with Verizon customer service performance in recent years. Ms. Pariseau was particularly concerned about the deterioration in Verizon's performance in percentage of calls not answered in 20 seconds – residence, and percent of installation appointments not met – Company reasons. Tr. 9/21/07 at 149. The most dramatic increase in consumer complaints against Verizon has come in the area of repair, where, Ms. Pariseau testified, "complaints jumped over 100% in the period of 2002 through 2006." Pariseau Direct, p. 7. Ms. Pariseau concluded, based on the complaint data and from her own familiarity with the substance of the complaints, that "consumers are experiencing more and more serious problems with Verizon in the areas of repair, delivery of service, and line extensions." Id.

Verizon witness Pamela J. Porell testified that both Dr. Peres and Ms. Pariseau ignored the performance of Verizon as a whole, failing to consider where Verizon has met its Retail Service Quality Plan requirements, and where its performance has improved in recent years. See, e.g., Porell Rebuttal, pp. 3-4. Ms. Porell also argues that the Service Quality Plan standard for Residential Trouble – Not Cleared in 24 Hours, which Verizon failed to meet in each year from 2002 through 2006,[11] is too challenging, implying the Board should not expect Verizon to meet this standard. Ms. Porell's arguments miss the point of the Peres (and Pariseau) critiques of Verizon's recent service quality performance.

Verizon, through the testimony of Ms. Porell, essentially argues that any recent deficiencies in key service quality metrics should be considered offset by adequate or improving performance in other service quality metrics, or that the standards are too difficult to meet. With respect to the offsetting performance argument, Dr. Peres points out that Verizon has allowed service quality to deteriorate for some key metrics recently, while barely meeting its service quality obligations in other areas. Labor St. 3-R at 17-21. Ms. Pariseau similarly rejects the idea that adequate performance in some areas justifies substandard performance in other areas. Pariseau Rebuttal, p. 5.

With respect to the argument that a maximum of 30% residential troubles not-cleared-within-24-hours is too "challenging" for Verizon, Dr. Peres observes this standard has been in place for many years, and that Verizon was able to deliver service that exceeded this benchmark in 2000, when only 20% of residential out of service troubles were not cleared within 24 hours,

[11] Labor St. 3-R at 19, Chart Two.

and in 2001 when only 24.3% were not cleared on time. As Dr. Peres states, “Verizon’s own performance has proven that it can meet the current standard.” Labor St. 3-R at 20. Verizon has simply chosen not to expend the resources necessary to prevent deterioration in this and other metrics of service quality. FairPoint will have to spend considerable resources to make up for this backlog.

FairPoint will be further challenged to succeed in bringing service quality up to adequate levels, because Verizon has also left service quality inadequately supported in the other two Northern New England states FairPoint proposes to acquire. These deficiencies will add to the cost of labor and capital investment needed to reverse Verizon’s trends in recent years. Dr. Peres testified that Verizon New Hampshire had the worst performance of the three states in relation to out-of-service intervals in hours for both residential and business customers in 2005 and 2006. Labor St. 3 at 14. Similarly, a recent report by a hearing examiner with the Maine Public Utilities Commission (PUC) stated:

> …a review of Verizon’s service quality results during the current AFOR [Alternative Form of Regulation in effect since 2001] reveals that service quality has declined. ...Last year and this year, the performance [in a key metric] is even worse.

Investigation into New Alternative Form of Regulation for Verizon Maine Pursuant to 35-A M.R.S.A., §§ 9102-9103, Examiner’s Report (Revenue Requirement and Service Quality Issues), May 9, 2007, Maine Public Utilities Commission, Docket No. 2005-155, p. 247, quoted in Labor St. 3 at 14.

In response to the degradation of service quality in Maine, the hearing examiner recommended tightening the service quality index, and increasing penalties. Labor St. 3 at 14. Again, the problem cannot be fixed by replacing Verizon with a firm that is not capable of fixing the deficiencies left by Verizon.

The service quality risks occasioned by the shakiness of FairPoint's financial situation are compounded by FairPoint's lack of comprehensive knowledge of the state of Verizon's plant. See, e.g., Tr. 9/19/07 at 200-202, 212-215; Tr. 9/20/07 at 7-8. If significant portions of Verizon's infrastructure in Vermont require upgrades beyond those assumed in FairPoint's financial planning, the pressure on FairPoint's ability to meet its investment requirements will increase. The result is a further risk that service quality will not be brought up to standards, and a likelihood that it will not improve.

Verizon should not be rewarded for ignoring its obligations in Northern New England by allowing it to hand off its system "as is" to another entity, at a substantial profit, regardless of that entity's ability to spend what it takes to ensure high quality service. The Board must satisfy itself that the prospective owner and operator of landline service for the vast majority of Vermonters is capable of, and likely to, bring service quality in the Verizon service territory in all measured areas up to minimum standards, and to maintain it at required levels.[12]

C. In Addition to Limited Financial Resources, FairPoint's Ability to Bring Service Quality to Acceptable Levels Will Be Challenged by the Potential Loss of Significant Numbers of Experienced Workers.

If the proposed transaction is approved, Northern New England risks a mass exodus of experienced Verizon workers. Labor St. 3-R at 2. As Dr. Peres points out, the potential impact on specific Vermont worksites and job titles could be significant. Id. at 3. According to Dr. Peres, if only a small number of workers leave, then FairPoint could probably deal with the issues of backfilling and training. Id. at 15. However, if large numbers of workers leave, then FairPoint will be hard pressed to find and train the needed replacements in a timely fashion. Dr. Peres also points out that, even if FairPoint could hire enough new workers to fill the slots of

[12] Bringing superior quality to service in Vermont would, *a fortiori,* require more resources than needed to bring service quality up to minimally acceptable levels.

those who leave, there will still be major problems due to the loss of experience. Labor St. 3 at 17-18, Labor St. 3-R at 15.

Already, Verizon employees are seeking assignments and transfers to Verizon's operations in Massachusetts or other states. Conversely, employees in other states no longer bid on jobs in Maine, New Hampshire and Vermont, which previously obtained many such bids. Labor St. 3 at 17. This anecdotal evidence of employees "voting with their feet" on the proposed transaction does not indicate confidence of the workforce in the prospective new Northern New England ownership. Union officials also have received numerous reports from employees of their intentions to resign if the takeover is approved. Id.

To determine the reliability of these reports, Dr. Peres prepared and supervised a survey of the potentially affected employees. Under his direction, the CWA and IBEW distributed the survey to union-represented employees in the three states. Labor St. 3-R at 6. The survey was distributed during the last week of July and the first week of August 2007. Id. Over 1000 completed surveys were collected, accounting for more than 40% of the union-represented workforce. Id.

The survey was divided between pension-eligible employees and non-pension-eligible employees. Both groups were asked similar questions. The first question asked whether the surveyed employees were seriously considering leaving the company if the proposed transaction is approved and they would become employees of FairPoint. The second question asked these same workers whether they would seriously consider leaving the company if the transaction is not approved and they would remain employees of Verizon. Id. at 6-7.

The responses to the survey confirm the anecdotal evidence of worker distrust of FairPoint, and the likely loss of significant portions of the current workforce if the transaction is approved. Fifty-six percent of all the employees returning the survey stated that they would seriously consider leaving the company if the transaction were approved. However, only 7% said they would seriously consider leaving the company if the transaction were not approved. Id. at 9. Thus, on net, almost half of those surveyed, or 504 union-represented employees, are seriously considering leaving the company solely because of this transaction. Id. Extending these survey results to the entire union-represented workforce in the three states, Dr. Peres testified, one can conclude that more than 1,200 workers currently employed by Verizon across the region are seriously considering leaving the company if the transaction is approved. Id. As Dr. Peres notes, this is an astounding possibility. Id. The overall results of the survey calculated by combining the two groups (pension-eligible and non-pension-eligible employees) present a grave picture for FairPoint, and its customers, if the transaction is approved. Id.

The survey also illustrates the significant risk of a mass exodus of pension-eligible employees in the three-state region if the transaction is approved. Eighty percent of the pension-eligible employees who returned the survey stated that they will seriously consider retirement if the transaction is approved. If the transaction is not approved, only 12% of the pension-eligible employees in NNE would seriously consider retirement. Thus, a net 68% of the pension eligible workers who were surveyed are seriously considering leaving their current employment solely because of the transaction Id. at 9-10.

There also is a significant risk that non-pension-eligible workers will leave the company if the transaction is approved. Id. at 10. Almost half (46%) of non-pension-eligible employees stated that they will seriously consider leaving the company if the transaction is approved, while only 4% would seriously consider leaving if the transaction is not approved. Id. If the surveyed employees act on their intentions, a net amount of nearly 300 non-pension-eligible employees would leave the company. Id. at 10-11.

Looking specifically at responses of Verizon employees in Vermont, 216 Vermont employees (43% of the union-represented workforce) responded to the survey. Id. at 2. Fifty-three (53%) percent of the Vermont respondents stated that they would seriously consider leaving their current employment if the transaction were approved, but only 14% said they would seriously consider leaving if the transaction were not approved. Id. at 2-3. Thus, 39% of the Vermont respondents stated that they are seriously considering leaving their current employment solely because of a FairPoint take-over. Id. at 3.

Extending these survey results to the entire union represented workforce in Vermont indicates that almost 200 Verizon Vermont employees are seriously considering leaving the company if the transaction is approved. Id. at 11. Dr. Peres analyzed the response data, and determined that in Vermont, the ranks of State Craft Assistants (who inspect contract work) and Equipment Installation Technicians (who install equipment in the central offices such as switches and DSL connections) will be devastated. Eleven of the 15 Vermont employees in these job titles are seriously considering leaving if the transaction is approved. Id. Dr. Peres also observed that specific Vermont worksite locations also could be hit hard. For example, one-half of the workers in the Newport Garage are seriously considering leaving the company if the transaction is approved, and 9 of the twenty-one splicers at the Middlesex garage are seriously considering leaving if the transaction is approved. Id. at 11-12. If these employees leave as a result of a FairPoint takeover, the new owners will be left with dangerously low staffing levels in critical positions.

Survey results for New Hampshire and Maine paint a similar picture of a post-transaction work force with potentially gaping holes that would be hard for FairPoint to fill. Extending the survey results to the entire union-represented workforce in New Hampshire indicates that almost 500 workers currently employed by Verizon are seriously considering leaving the company if the transaction is approved. Id. at 12. In Maine, applying the survey results to the entire union-represented workforce suggests that 550 Verizon employees in that state are seriously considering leaving the company if the transaction is approved. Id. Because, as Ms. Porell acknowledged, Verizon manages its Northern New England workforce so as to allow employees to be loaned to neighboring states to meet specific needs (Tr. 9/17/07 at 115-116) Vermont will be adversely affected by labor shortages or shortages of experienced workers in the other Northern New England states.

Dr. Peres acknowledged that the survey does not prove that the indicated numbers of employees will definitely leave their positions if the transaction is approved. Id. at 14. The magnitude of the response, however, as well as the comments made concerning FairPoint's weak financial position, indicate a strong possibility that many experienced workers will leave if the transaction is approved. Id. It takes 42 months for a new Verizon technician to be considered fully trained and able to work independently. This time period may well last longer in FairPoint's case, since the experienced mentors that make on-the-job training possible may no longer exist in sufficient numbers. Labor St. 3 at 17-18.

FairPoint could face an immediate jobs crisis due to the loss of pension-eligible workers alone. Labor St. 3-R at 7. As positions go unfilled, or are filled with inexperienced workers, the remaining workforce also will see a degradation in their work experience, which is likely to engender more difficulties in bringing service quality up to standards.

Compounding the seriousness of the prospective loss of skilled employees, FairPoint management has not provided any indication that they are concerned about the issue. Nor has FairPoint developed contingency plans to deal with the possibility that significant numbers of workers will leave the company if the transaction is approved. Labor St. 3-R at 14.

In summary, there are strong indications that FairPoint's ability to provide reliable service, address long-standing deferred maintenance issues, and implement its broadband deployment plans may be jeopardized by the loss of hundreds of experienced employees. FairPoint has not convinced Verizon employees that FairPoint would be a stable, long-term employer that would provide reasonable compensation, benefits, and working conditions. Moreover, it does not appear that FairPoint considers this to be a serious risk, so it has not developed plans to deal with the potential loss of a significant percentage of Verizon's skilled workforce.

D. FairPoint Has Not Demonstrated a Commitment to Consistently High Quality Service in Vermont or Maine.

FairPoint Northland, the Vermont subsidiary of FairPoint, has not demonstrated a commitment to consistently high service quality in Vermont. FairPoint has had a relatively high disconnect rate, and high rates of customer complaints. Labor St. 3 at 7.

The disconnect rate reflects a company's willingness to work with consumers who may be hard pressed to pay their bills on time. Id. at 8. In 2004, FairPoint had a disconnect rate of 78 per 1,000 residential customers. By contrast, the statewide weighted average in 2004 for Vermont's ten incumbent local exchange companies was 60 per 1,000. Id. In 2006, FairPoint's disconnect rate was 90 per 1000, in comparison to Verizon's 61 per 1000. Id. Overall, FairPoint's disconnect rate was higher than the statewide average for incumbent local exchange companies in four of the last five years. Though not the highest rate in the state, FairPoint's disconnect rates were worse than average. Id.

FairPoint's rate of consumer complaints to the Department of Public Service last year was 2.4 per 1,000 access lines. Id. This rate was significantly higher than Verizon's rate of 0.46 complaints per 1,000 lines. Id. Also, in six of the last seven years, FairPoint had the highest rate of complaints of Vermont's ten local exchange companies – including Verizon. Id.

Such indifference to persistent service quality issues is not limited to Vermont. FairPoint has had significant service quality problems in Maine. For example, the Bangor Daily News reported that:

> "FairPoint's six Maine subsidiaries had among the highest rates of complaint for service, disconnection notice and billing in 2005 and '06, according to [Maine] PUC documents, and one of its companies, China Telephone, appears to have had the highest complaint rate in both years."

Bangor Daily News, FairPoint Comes Calling, January 18, 2007, cited in Labor St. 3 at 9.

E. FairPoint's Own Track Record of Cutovers and New Business Ventures Does Not Bode Well for Successful Development of the Dozens of New Systems Needed to Provide Quality Service, Nor for Successful Transition from Verizon.

To accomplish the proposed transaction, FairPoint must simultaneously acquire or develop, test, implement, maintain, and manage dozens of systems and processes which provide the functionality currently performed by over 600 Verizon operational, support and administrative systems. Labor St. 3 at 10. But FairPoint has had difficulties managing the transfer of a much smaller set of functions, with resulting adverse impacts on customer service.

FairPoint has been in the process of centralizing and outsourcing its billing and related customer care operations for its operating subsidiaries. Id. at 9. In late 2005 the contractor that performed these outsourcing functions decided to sell its underlying software and would not add any more customers to its service bureau platform. Id. By this time, FairPoint had already converted 17 of its then 28 operating subsidiaries to the outsourced system. Id. Ultimately, FairPoint transferred this project to another firm. Id. This disruption in the effort to outsource development of billing and related customer care software led to the service, disconnection notice, and billing problems experienced by FairPoint's Maine customers. Id. at 9-10.

FairPoint's experience in Maine provides an example of the types of problems that could arise when FairPoint attempts to develop and integrate new operational, support and administrative systems for numerous functions, including some it has never performed before (such as wholesale provisioning). FairPoint's management has not demonstrated its ability to succeed at a systems transfer of the magnitude that would be required if this transaction is approved.

The experience and financial resources of a prospective successor to Verizon are crucial to a successful transfer. This reality was borne out when Verizon sold its Hawaii landlines to a Carlyle Group subsidiary, Hawaiian Telcom, in 2005. Labor St. 1 at 30. Hawaiian Telcom experienced significant problems with its cutover, despite having in place a transition services agreement similar to that between FairPoint and CapGemini in this case. Id. Hawaiian Telcom spent $100 million on new operations systems to handle the functions that previously were conducted by Verizon. The company experienced many problems with its new billing systems. The company hired an additional 120 employees. But the customer service problems still persisted. Id.

As of November 2006, according to Moody's Investor Services, Hawaiian Telcom had not managed to develop the systems it needs to function as a stand-alone business, and a "continuing delay in creating fully functioning back office systems [in turn] is contributing to numerous operational problems (i.e., customer care, order management, billing, and financial reporting) and distracting senior management." Id. at 30-31. See also, *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*, 2005 Haw. PUC LEXIS 125 (HI PUC March 16, 2005). Ultimately, Hawaiian Telcom replaced its information technology and related services consultant. Labor St. 1 at 31.

As Mr. Barber notes, the experience of Hawaiian Telcom and its transition services agreement (TSA) should act as a cautionary tale for regulators examining the proposed Verizon-FairPoint transaction. Id. There are important similarities between the two transactions. In both transactions, Verizon is selling 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 entered into a TSA with Verizon to smooth the transition process. Id. However, a crucial difference between the two situations is that the Carlyle Group had major financial resources it could extend to Hawaiian Telcom if it so desired. FairPoint will not have access to such resources. Id. at 31-32. If anything, FairPoint's ability to manage the transition without experiencing the problems Hawaii has faced will be constrained.

While there are always transitional challenges when telephone company operations are transferred to an experienced company's existing systems, that transaction can occur smoothly, as witnessed by the Verizon sale of its landline operations in Kentucky to Alltel, and the sale of its Alabama and Missouri landline operations to CenturyTel . Id. at 32. Alltel and CenturyTel were largely able to integrate Verizon's operations into their own existing systems and operations centers. Id. That will not be the case here. The proposed deal with FairPoint is so large that FairPoint cannot integrate NNE into existing FairPoint systems. Id., lines 19-20. Instead, FairPoint will have to develop dozens of complex systems and operations from scratch in order to attempt to run the NNE operations. Id. FairPoint will be hard pressed to accomplish a cutover from Verizon's systems and operations without its customers facing potentially major disruptions to service quality and customer service.

In short, there is nothing in the experience of FairPoint that even approaches the magnitude of what it is attempting to do here. FairPoint had problems handling the conversion of its billing system. Now it is attempting to not only convert Verizon's billing system, but to simultaneously convert hundreds of other functions to dozens of new operational and support systems. The only other time such a task was attempted on this scale was in Hawaii where the results were disastrous. While FairPoint and Verizon claim that they will learn from the mistakes in Hawaii, that's a far cry from providing assurances that FairPoint will have the capabilities to convert to these new systems, let alone train thousands of people on their use while simultaneously trying to run a multi-state telecommunications network. At the risk of understatement, it is fair to say that the potential for service quality problems is high, and the assurances provided by FairPoint are non-existent.

F. FairPoint's Constrained Financial Situation Will Undermine its Ability to Achieve and Maintain High Quality Service Levels.

Any Verizon successor will have to expend more than Verizon has in recent years on labor and capital investments, just to bring the system up to minimum standards.[13] Labor St. 3-R at 16. By rights, Verizon should be making this investment. However, that is not how this

[13] FairPoint agrees that improvements in service quality cannot be achieved without investments in labor and capital. Mr. Nixon, FairPoint's Chief Operating Officer, testified that employing "capital and other resources is important to service quality" (Nixon Direct, p. 32).

proposed deal is structured. The burden will fall to FairPoint. But FairPoint will not have the financial resources to bring service quality in Verizon's territory up to minimal standards, much less improve it.

As Mr. Barber shows in his testimony, FairPoint will face very difficult challenges simply finding the resources to properly operate and maintain the NNE properties as they are today, much less investing sufficient resources to improve Verizon's recent (and insufficient) performance:

> 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.

Labor St. 1 at 7; *see also* id. at 22.

According to Mr. Barber's analysis, 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. Id. at 33.

As discussed above, FairPoint is likely to have to increase spending above Verizon's recent trends in order to make up for Verizon's neglect, and resulting service quality problems. But, as discussed in Section III.C., above, FairPoint's operating expense projection is woefully inadequate.

Other state commissions have expressed concern with FairPoint's ability to provide adequate service while maintaining its financial integrity. Labor St. 3 at 10. In 2005, FairPoint acquired the Berkshire Telephone Company in New York.   The New York Public Service

Commission (NY PSC) was so concerned about FairPoint's "relatively weak financial position" that it felt compelled to impose a significant number of conditions on its approval of the company's acquisition of Berkshire Telephone Company. Labor Exh. 7. These conditions were imposed to protect the new subsidiary's financial health, capital investment, service quality and consumer rates. The conditions included the following:

- a service quality plan with the suspension of dividend payments and the imposition of customer rebates for substandard service;
- cost savings to flow to consumers;
- limits on dividend payments equivalent to the difference between EBITDA (earnings before interest, taxes, depreciation and amortization) and 100% of depreciation expenses in order to ensure adequate capital investment;
- limitations on dividend payments, debt and inter-affiliate transactions in order to limit the ability of FairPoint to use Berkshire as a cash cow.

Dr. Peres points out that the NY PSC imposed these conditions in the context of a small transaction ($20.3 million and 7,200 access line equivalents) with dramatically smaller attendant risks than the instant proposal – both to FairPoint and the business it was acquiring. Labor St. 3 at 11.

In short, as discussed in detail in Section III, above, FairPoint's financial constraints are likely to seriously affect the company's ability to provide reliable service to its customers. These impacts could be felt both during the transition and in the future as FairPoint's financial condition continues to deteriorate.

G. Because of FairPoint's Inability to Show that it Will Meet the Service Quality and Customer Service Standards Required for Approval, the Board Should Reject the Proposed Transaction.

As Dr. Peres testified, the best way to protect consumers from the serious risks of the proposed transaction would be for the Board to deny it. Labor St. 3 at 21; Labor St. 3-R at 4.

FairPoint cannot show that it will satisfy the service quality criteria, given the paucity of its available resources, the deficits in Verizon service quality that any successor will have to rectify, the daunting challenge of developing and flawlessly implementing an entire suite of new operations systems, FairPoint's own difficulties managing a much smaller transition in Maine, and FairPoint's lackluster approach to service quality in its existing Vermont and Maine service areas.

Given the difficulties experienced in regulating Verizon, the Board may be tempted to allow Verizon to dump its system on "anybody but Verizon." Labor St. 3-R at 16. Unfortunately, this would simply reward Verizon's poor performance, and in this case, would leave consumers open to grave risks of serious service quality troubles. Instead, this transaction should be rejected.

The risks of allowing FairPoint to assume ownership of Verizon NNE are simply too great. As Dr. Peres testified, rejecting this transaction would send "a very significant message to Verizon." If Verizon still wants to sell its operations, "it would have to find a buyer that would actually have the requisite financial resources, the operational resources and capacity and the experience" needed to provide reliable service. Tr. 9/20/07 at 41-42.

H. If the Board Determines to Approve the Proposed Transaction, It Should Strengthen the Service Quality Standards Applicable to FairPoint's Service Areas, and Enhance the Penalties to the Point They Ensure FairPoint Will Devote the Resources that Will Be Required. It Also Should Require FairPoint to File a Plan to Address the Risk of Employee Loss.

If the Board determines that FairPoint's severe financial deficiencies can be overcome (which, as Mr. Barber explains, does not appear likely), and thus if the Board considers approving the merger, IBEW and CWA recommend that it should do so only if the transaction is conditioned on stringent service quality requirements, backed up by financial consequences sufficient to avert a "pay to play" response from FairPoint management. Labor St. 3 at 4. Labor Intervenors also would recommend conditions intended to address FairPoint's lack of planning for possible workforce depletion.

With respect to service quality and customer service, as Dr. Peres outlines, the Board should impose the following conditions on any transaction approval:

- Require FairPoint to adopt with the Verizon Amended Retail Service Quality Plan's Service Quality Index (SQI).

- Further extend the SQI term to five years following the successful "cutover" of all operations and systems to FairPoint.

- Strengthen the SQI by requiring FairPoint to report the trouble-report rate and the percentage-out-of-service-over-24 hours for each individual exchange in the state, in addition to the current statewide reporting requirement.

- Adopt a new baseline for the percent of calls not answered within 20 seconds, for residence and business calls. The baseline should be changed from 25% to 20%, requiring that the company answer an average of 80% of the calls from customers who want to speak to a live customer service representative within 20 seconds.

- Adopt a new performance standard that would trigger service-compensation points whenever an exchange experiences a customer-trouble-report rate or a percentage-out-of-service-over-24-hours rate that is 20% greater than the baseline.

- Adopt a new baseline for the percent troubles not cleared within 24 hours – residence: the baseline should be changed from 30% to 20%.

Labor St. 3 at 4 and 23-24.

The Board also should amend the SQI to impose double penalties for each category in which substandard service is delivered for two years in a row, and double the total dollar amount at risk. Labor St. 3 at 24. Finally, regarding the SQI, if FairPoint fails to meet any individual transaction benchmark for three consecutive years, the Board should conduct an extensive service quality audit that would document the reasons for poor service quality performance and make specific recommendations to improve service quality. Id. These conditions take on added importance on account of the probable exodus of experienced workers, as well as the gap between FairPoint's stated promises and intentions on the one hand and its lack of any stated enforceable commitments.

As to establishing an SQI lasting until 5 years past the cutover, this condition would be different from FairPoint's agreement to comply with the Amended Retail Service Quality Plan that forms part of the Alternative Form of Regulation. The primary difference is that the current SQI will expire in 2010. Labor Intervenors recommend that the SQI imposed as a condition of any approval of this transaction (transaction SQI) be in force at least 5 years after the cutover, to ensure continuous application of the remedy past the immediate cutover experience. Any litigated renewal or change to the SQI could be a time-consuming process.

As to the recommendation that the Board strengthen the SQI as a condition of any transaction approval, the goal of any transaction approval should be to improve service, and maintain improved service over a number of years. Setting the baseline for percent-troubles-not-cleared-within-24-hours-residence at 20% is more important than ever as residential consumers rely increasingly on their telecommunications link for more business and personal services. Labor St. 3 at 23. The total lack of telephone and internet availability for more than 24 hours subjects customers to greater harms than in the past. Id. In addition, technological improvements should have improved the ability of companies to clear their lines speedily. Id. As Dr. Peres points out, there is little reason for almost a third of consumers to experience out-of-service conditions for more than 24 hours – especially given FairPoint's assurances that service quality will improve. Id.

Reducing the baseline for the percent of calls not answered within 20 seconds for residence and business calls from 25% to 20% would merely require FairPoint to meet the same baseline that currently exists for repair centers. Id. Technology has changed enough so that customer service calls are now routed more efficiently than in the past. Thus, there is no reason a major telecommunications carrier should have slower response time for customer service calls than it has for repair calls. Id.

Doubling the penalties if service falls below any benchmark for two consecutive years, both in terms of each individual component of the transaction SQI and the total dollar amount at risk, would provide an incentive for FairPoint to fix problems as they occur. Id. at 24. The eroded quality of Verizon's customer service, coupled with FairPoint's plans to divert maintenance and capital investment in favor of dividend payouts, suggests that stronger penalties are needed to keep FairPoint from allowing service quality to slip even further when it feels financial pressures.

If these measures are not enough to induce adequate service quality, the proposed comprehensive service quality performance audit would provide a form of backstop against FairPoint indifference. If FairPoint fails to meet any individual transaction SQI benchmark for three consecutive years, an audit would be conducted by an independent outside auditor, directed by the Board and paid for by FairPoint. Labor Intervenors recommend that the audit include, but not be limited to, (a) the amount of network investment and resources dedicated to improving service quality, and the mix of these resources, (b) the adequacy of company records to locate and correct deficient equipment in a quick and efficient manner, and (c) the available workforce and the expected workload. The audit should document the reasons for poor service quality performance and make specific recommendations to improve service quality. The Board, as a condition for any transaction approval, also should include a provision to require FairPoint to implement any of the audit's recommendations that the Board adopts, to assure compliance with the service quality performance standards. Id.

Given the need for FairPoint to maintain a skilled and experienced workforce, the Board also should require FairPoint to develop a detailed plan to address the probability that a significant number of employees may leave their employment if the transaction is approved. This plan should (a) specifically identify the number, job title and location of likely job losses, and (b) map out a plan for backfilling positions and training replacements. Id. at 14-15. The public interest would not be well served if FairPoint took over Verizon's operations only to find that it faced a major jobs crisis without adequate plans to rectify the problems in a timely and successful manner.

V. Recommended Board Action

A. The Proposed Transaction Does Not Promote the Public Good. The Board, Therefore, Must Reject the Transaction.

Labor Intervenors have explained above that the proposed transaction does not promote the public good. FairPoint is not financially stable and sound, which is likely to result in severe constraints on its ability to provide safe and reliable service in Vermont. Even under FairPoint's wildly optimistic financial assumptions, the company would not be financially stable. Under more realistic assumptions, FairPoint would be on the brink of financial collapse – approaching or exceeding the "worst case" scenario that was presented to FairPoint's board of directors.

These financial constraints – including lenders' restrictions on the level of FairPoint's capital expenditures – are likely to be so severe that they will directly affect FairPoint's ability to provide safe and reliable service to its customers. Everyone seems to recognize the challenge that FairPoint faces to try to improve the quality of service Verizon now provides. But without adequate financial resources, without enough people, and without the ability to invest in new plant and equipment, FairPoint will be unable to meet that challenge.

The Board may find instructive a decision issued by the Montana Public Service Commission earlier this year. In *NorthWestern Corp.*, 2007 Mont. PUC LEXIS 54 (Mont. PSC July 31, 2007)[14], that commission rejected a proposed merger and acquisition because, in its words: “The overriding issue in the docket is whether the proposed transaction poses a threat to NorthWestern's financial health and, therefore, harm or risk of harm to Montana customers. The Commission finds that it does and explains its reasons below.” Id. ¶ 143.

The Montana commission’s analysis is directly applicable to this case. Indeed, the Montana commission found that its primary financial concern was that the acquiring company (BBIL) was projecting that it would require the utility (NorthWestern) to pay out more in dividends than the utility earned in net income. As the commission stated: “First and foremost, BBIL assumes NorthWestern will consistently pay out dividends to its new owner in excess of NorthWestern’s net earnings. While U.S. utilities typically pay out 60 to 70 percent of net earnings in dividends, BBIL’s acquisition model calls for in excess of 100 percent of net earnings to be paid out annually by NorthWestern through the year 2023.” Id. ¶ 148.

The commission then explained as follows why this was so problematic for a public utility: “In normal utility operations, retained earnings provide a vital source of financial strength for capital investment and as reserves that are available during unexpected financial strains. Regularly paying out dividends in excess of net earnings by a utility is inappropriate and risky because having insufficient reserves on hand could adversely affect the utility's ability to provide adequate service.” Id. ¶ 149.

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[14] The order is also available on the Montana commission’s web site at:
< http://www.psc.state.mt.us/eDocs/eDocuments/pdfFiles/D2006-6-82_6754e.pdf >. Citations are to the numbered paragraphs in the order, which are the same in either the Lexis or web site versions of the order.

Based on the acquiring company's financial projections, as well as its history of operations elsewhere, the commission concluded: "Given BBIL's dividend expectations and practices and the highly leveraged capital structures that BBIL has implemented at its existing operating subsidiaries, as well as the financial projections in the acquisition model, it is evident that BBIL's proposed ownership of NorthWestern presents the likelihood that NorthWestern's capital structure will deteriorate and become unacceptably leveraged." Id. ¶ 156 (emphasis added).

The Montana commission concluded, therefore, that the proposed purchaser was not financially viable and that the transaction was too risky for consumers. The commission decided that the existing utility's ownership was preferable to a new owner that was not financially viable. This was particularly true where that lack of viability would lead to the deterioration of the utility's capital structure. Thus, the commission concluded: "The Commission prefers the model of a stand-alone NorthWestern continuing to improve its financial outlook to the prospect of a BBIL-owned NorthWestern that is making excessive equity distributions to its owner, retaining insufficient earnings at the utility level, and experiencing a deteriorating capital structure – all to the detriment of the utility and Montana customers." Id. ¶ 180.

Each of the Montana commission's findings applies equally to FairPoint. Labor Intervenors submit, therefore, that the Board should follow the reasoning of the Montana commission and reject this transaction. The proposed transaction is inconsistent with the public good and would expose the Vermont utility and the public to extraordinarily high financial risk, which is likely to lead to the deterioration of service.

Labor Intervenors recognize that Verizon has presented challenges to regulators. But it can get worse for Vermont, conceivably much worse, if this transaction is approved.

As Dr. Peres explained, rejecting this transaction would send "a very significant message to Verizon." First, if Verizon still wants to sell its operations, "it would have to find a buyer that would actually have the requisite financial resources, the operational resources and capacity and the experience" needed to provide reliable service. Second, if Verizon chooses to retain the business, "it would have to change its operating plan and focus more on service quality." Tr. 9/20/07 at 41-42.

B. If the Board Disagrees, Then The Board Must Impose Stringent Conditions to Protect the Public from Some of the Adverse Consequences of FairPoint Ownership.

1. Introduction

If the Board disagrees and believes that it is possible to condition the transaction in such a way that the transaction would serve the public good, then Labor Intervenors submit that those conditions should accomplish three goals: (1) fundamentally change the nature of the transaction and the nature of FairPoint's operations going forward; (2) restrict FairPoint's financial decision-making so that the Vermont operations are required to retain adequate capital; and (3) ensure that service quality performance standards are coupled with strong financial incentives for compliance, eliminating the payment of penalties or credits as a viable business decision.

At the outset, though, Labor Intervenors would note FairPoint's reluctance to be bound by any serious financial conditions. Thus, for example, FairPoint witness Leach testified that the company's lenders would not permit FairPoint to agree to any restrictions on dividend payments. Leach rebuttal p. 63. In response to questioning, however, he acknowledged that FairPoint had in fact agreed to precisely these types of conditions in two other jurisdictions: New York and Illinois. Tr. 9/5/07 at 146-156; Labor Exhs. 4-7.

Moreover, earlier this year, FairPoint went back to the Illinois Commerce Commission for approval of the change in control that would be part of the proposed transaction. On June 27, 2007, the Illinois commission issued an order that approved the change in control, but required FairPoint to continue to be bound by those same dividend and cash transfer restrictions going forward. *FairPoint Communications Inc.*, Docket No. 07-0191, slip op. (Ill. Commerce Comm'n June 27, 2007).[15]

Yet before this Board, FairPoint takes the position that it should not be subject to similar restrictions, and that its lenders would not permit it. FairPoint has failed to explain why it is permissible for its New York and Illinois consumers to have the protection of dividend restrictions, but it is impermissible for Vermont consumers to receive the same protection.

Similarly, FairPoint has not explained why it should not be bound by the same types of cash transfer restrictions – usually termed "ring fencing"[16] – that have been imposed on utility holding companies in several other states. For example, just during 2007 utility commissions in California, Colorado, Iowa, Oregon, and Washington have issued orders in cases involving mergers and reorganizations that contain precisely these types of restrictions.[17]

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[15] A copy of the Illinois commission's order is available through its e-docket system at:
< http://www.icc.illinois.gov/e-docket/reports/view_file.asp?intIdFile=200379&strC=bd >

[16] The California Public Utilities Commission recently defined ring fencing as follows: "Ring-fencing is the legal walling off of certain assets or liabilities within a corporation. Conceptually, in the context of a public utility within a holding company structure, ring-fencing includes a number of measures that may be implemented to protect the economic viability of the utility by insulating it from the potentially riskier activities of unregulated affiliates and thereby, ensuring the utility's financial stability and the reliability of its service." *Joint Application of SFPP, L.P. (PLC-9 Oil), CALNEV PIPE LINE, L.L.C., KINDER MORGAN, INC., and KNIGHT HOLDCO LLC*, 2007 Cal. PUC LEXIS 227 (Cal. PUC May 24, 2007), citing Beach Andrew N., Gunter J. Elert, Brook C. Hutton, and Miles H. Mitchell. Maryland Commission Staff Analysis of Ring-Fencing Measures For Investor-Owner Electric and Gas Utilities. The National Regulatory Research Institute-Volume 3, December 2005 at page 7.

[17] *Joint Application of SFPP, L.P. (PLC-9 Oil), CALNEV PIPE LINE, L.L.C., Kinder Morgan Inc., and Knight Holdco LLC*, 2007 Cal. PUC LEXIS 227 (Cal. PUC May 24, 2007); *Joint Application Of Kinder Morgan, Inc. Rocky Mountain Natural Gas Company, KN Wattenberg Transmission L.L.C., Source Gas Distribution, LLC, KM Retail Utility Holdco, LLC, Knight Holdco LLC, and Knight Acquisition Co.*, 2007 Colo. PUC LEXIS 174 (Colo. PUC Feb. 26, 2007); *Aquila, Inc.*, 2007 Iowa PUC LEXIS 341 (Ia. Util. Bd. Aug. 31, 2007); *MDU Resources Group, Inc.*, 2007 Ore. PUC LEXIS 242 (Ore. PUC July 25, 2007); *Application of Avista Corp.*, 256 P.U.R.4th 106 (Wash. UTC Feb. 28, 2007); *MDU Resources Group, Inc.*, and 2007 Wash. UTC LEXIS 411 (Wash. UTC June 27, 2007).

2. Fundamental Changes in Verizon and FairPoint

Mr. Barber proposed that the only way to condition the transaction to serve the public good was to fundamentally change the transaction. Specifically, he recommended that the amount of cash FairPoint would have to pay should be severely reduced. This would be accomplished by requiring Verizon to bring its network up to standards – service quality standards, network operations, broadband availability, maintenance (such as the elimination of double poles) – prior to the system being turned over to FairPoint. Indeed, this could even include Verizon being required to provide FairPoint with a viable back-office operation (which could be achieved by having Verizon pay the TSA costs and the costs being incurred by FairPoint to Capgemini to build those systems). Labor St. 1-R at 43.

This would be coupled with a commitment by FairPoint to eschew its history as an acquisitions company and effectively become the northern New England telephone company. Thus, FairPoint would need to dedicate itself to becoming, in Barber's words, a "world class telecom operating company." Id.

3. Financial Conditions

Mr. Barber suggested the following financial conditions, which are modeled on the conditions FairPoint agreed to in Illinois and New York (Labor St. 1-R at 38-40):

1. NNE will be prohibited from paying dividends to FairPoint Communications Inc. (or any other affiliate thereof) (collectively "FairPoint Parent") or from otherwise transferring cash to FairPoint Parent through loans, advances, investments or other means that would divert NNE's moneys, property or other resources that is not essentially or directly connected with the provision of non-competitive telecommunications service if NNE fails to meet or exceed the standard for a majority of the service quality measures (see the testimony of Dr. Peres for the types of service quality conditions that should be established for FairPoint).

2. Dividends on common stock of FairPoint's existing operations in Vermont must be suspended if service quality at FairPoint's existing operations in Vermont deteriorates, using the same criteria to be established for NNE (as

discussed by Dr. Peres).

3. The financing for the acquisition will not be secured by NNE's assets, nor shall NNE or its affiliates be allowed to pledge NNE's assets.

4. NNE will not provide any financial guarantees to facilitate this, or any other acquisition.

5. The amount of annual dividends NNE can distribute to FairPoint Parent is further limited as follows:

    a. The cumulative dividend NNE can declare in any year may not exceed the difference between that year's earnings (income or loss) before interest, taxes, depreciation, and amortization (EBITDA) and 100% of its depreciation expense. This restriction will require that an amount of cash, equal to 100% of that year's depreciation expense, will be available for NNE's capital expenditures.

    b. In any year that the amount of depreciation expense retained by NNE is in excess of its capital expenditures, NNE shall account for such funds in a subaccount of Account 1410, Other Noncurrent Assets. The cumulative annual depreciation expense retained at NNE will assure adequate funds are available to complete future capital expenditures, as required.

    c. In years when the total depreciation expense does not cover capital expenditures, NNE may use the accumulated depreciation funds to pay for this incremental amount of capital expenditures, provided that NNE notifies the Commission of such a need no later than 45-days prior to the use of the funds.

    d. Suspend this dividend restriction to the extent NNE is able to maintain an average daily balance in the depreciation fund subaccount of Account 1410 for a calendar year of 1.0 times its average annual capital expenditures for the last five calendar years. The dividend restriction will become operative whenever this criterion is not satisfied. Further, we will suspend the restriction if FairPoint obtains an investment grade bond rating.

6. NNE must maintain a consolidated common equity ratio of at least 40% of total capitalization before any declaration of a dividend on common stock. Total capitalization includes: long term debt (including current sinking fund requirements), short term debt (including capital leases), minority interest, and stockholders' equity. Further, no dividend payment will be permitted which would cause NNE's consolidated common equity ratio to fall below 40%.

7. NNE and its subsidiaries shall be prohibited from making any loans or financial advances to FairPoint.

4. Service Quality Conditions

As explained in Section IV.H., above, if the Board decides not to reject the transaction, then it should adopt the following service quality conditions:

- Require FairPoint to adopt with the Verizon Amended Retail Service Quality Plan's Service Quality Index (SQI).
- Further extend the SQI term to five years following the successful "cutover" of all operations and systems to FairPoint.
- Strengthen the SQI by requiring FairPoint to report the trouble-report rate and the percentage-out-of-service-over-24 hours for each individual exchange in the state, in addition to the current statewide reporting requirement.
- Adopt a new baseline for the percent of calls not answered within 20 seconds, for residence and business calls. The baseline should be changed from 25% to 20%, requiring that the company answer an average of 80% of the calls from customers who want to speak to a live customer service representative within 20 seconds.
- Adopt a new performance standard that would trigger service-compensation points whenever an exchange experiences a customer-trouble-report rate or a percentage-out-of-service-over-24-hours rate that is 20% greater than the baseline.
- Adopt a new baseline for the percent troubles not cleared within 24 hours – residence: the baseline should be changed from 30% to 20%.
- Amend the SQI to impose double penalties for each category in which substandard service is delivered for two years in a row, and double the total dollar amount at risk.
- If FairPoint fails to meet any individual transaction benchmark for three consecutive years, the Board should conduct an extensive service quality audit that would document the reasons for poor service quality performance and make specific recommendations to improve service quality.

VI. Conclusion

For the reasons set forth above, the Communications Workers and America and the International Brotherhood of Electrical Workers respectfully request the Public Service Board to reject the Application. FairPoint Communications is not financially fit to own and operate Verizon Vermont and the other Verizon Northern New England operations. FairPoint Communications has not demonstrated either the commitment or expertise to provide adequate service to Vermont consumers on an on-going basis. There is no set of conditions that would cure these fundamental problems with the transaction. The Public Service Board, therefore, must reject the proposed transaction as being contrary to the public good.

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