STATE OF MAINE
PUBLIC UTILITIES COMMISSION

Docket No. 2007-67

November 26, 2007

VERIZON NEW ENGLAND INC., NORTHERN NEW ENGLAND TELEPHONE OPERATIONS INC., ENHANCED COMMUNICATIONS OF NORTHERN NEW ENGLAND INC., NORTHLAND TELEPHONE COMPANY OF MAINE, INC., SIDNEY TELEPHONE COMPANY, STANDISH TELEPHONE COMPANY, CHINA TELEPHONE COMPANY, MAINE TELEPHONE COMPANY, AND COMMUNITY SERVICE TELEPHONE CO., Re: Joint Application for Approvals Related to Verizon's Transfer of Property and Customer Relations to Company to be Merged with and into FairPoint Communications, Inc.

EXAMINER'S REPORT

PUBLIC VERSION

NOTE: This Report contains the recommendation of the Hearing Examiners. It does not constitute Commission action. Parties may file responses or exceptions to this Report on or before 5 p.m. on December 3, 2007. It is expected that the Commission will consider this report at a special deliberative session on December 13, 2007.

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I. SUMMARY

In this Report, the Examiners recommend that the Commission reject the Joint Applicants'[1] Petition for Approval. We find that, taken as a whole, the proposed Transaction subjects both ratepayers and shareholders to substantial risks and harms that are not outweighed by any of the potential benefits of the Transaction. We also recommend that the Commission specifically find that Verizon Maine has failed to meet its burden under 35-A M.R.S.A.§ 1104.

In the event that the Commission disagrees with our overall assessment, we include in this Report our recommendations regarding potential conditions the Commission could impose on the Joint Applicants that may ameliorate the risks and harms to ratepayers and shareholders that we discuss throughout this Report.

II. INTRODUCTION

The Transaction that lies at the heart of this proceeding is complex and multi-faceted. The litigation of this matter has generated huge volumes of paper. These materials have been reviewed closely by both the parties and the Examiners in an effort to fully understand the Transaction and its potential impact on Maine's telecommunications stakeholders (consumers, competitors, other telecommunications providers). Experience with other similar transactions, including the acquisition of Verizon's Hawaiian telephone local exchange carrier (LEC) operations by the Carlyle Group, has shown that a merger/acquisition such as this Transaction will have real,

[1] Verizon New England Inc., d/b/a Verizon Maine (Verizon), Northern New England Telephone Operations, Inc. (Telco), Enhanced Communications of New England, Inc. (Newco), Northland Telephone Company of Maine, Inc., Sidney Telephone Company, Standish Telephone Company, China Telephone Company, Maine Telephone Company, and Community Service Telephone Co. (the latter six being referred to as FairPoint Classic).

consumer-impacting results, either positively or negatively. Toward that end, the Examiners have tried not only to collect data and review testimony, but to evaluate what the available information means in relation to continued levels of service quality, the proliferation of advanced services, the viability of existing rates, and competition. This Examiners' Report consolidates the information that was provided and synthesizes it into sub-parts that can be used to address each of the issues the Commission will be required to resolve in reaching a final decision regarding whether to approve or reject the Transaction.

This Report generally follows the structure of the issues list that was provided to the parties at the beginning of the proceeding and which has been used to coordinate the litigation, including the technical conferences and hearings. For each of the four main topic areas, the Report will: (a) set forth the fundamental questions raised by each issue and explain its relevance to the overall proceeding; (b) set forth the position of the parties; and (c) state the Examiners' views regarding whether the Joint Applicants have met their legal burdens with regard to the issue and, in some circumstances, provide the Commission with conditions it may consider imposing on FairPoint and/or Verizon if the Commission rejects our overall recommendation to reject the request for approval of the Transaction.

III. PROCEDURAL HISTORY

A. Summary of Proposed Transaction

On February 1, 2007, Verizon New England Inc., d/b/a Verizon Maine (Verizon), Northern New England Telephone Operations, Inc. (Telco), Enhanced Communications of New England, Inc. (Newco), Northland Telephone Company of Maine, Inc., Sidney

Telephone Company, Standish Telephone Company, China Telephone Company, Maine Telephone Company, and Community Service Telephone Co. (the latter six being referred to as the FairPoint Maine Telephone Companies or FairPoint Classic) (collectively the Joint Applicants) jointly filed a request for the Commission to grant "any and all approvals and authorizations required for the transfer of Verizon New England's local exchange and long distance businesses and the long distance businesses of certain affiliated companies of Verizon New England to FairPoint Communications, Inc. (FairPoint), the commencement of the provision of regulated telephone utility services by Telco and Newco, the discontinuance of regulated telephone utility services by Verizon New England and the ancillary transactions." (the Transaction). The Joint Applicants filed similar applications before the New Hampshire Public Utilities Commission (NH PUC) and the Vermont Public Service Board (VT PSB).

Verizon serves as an incumbent local exchange carrier (ILEC) in Maine. Verizon is a direct, wholly-owned subsidiary of NYNEX Corporation and NYNEX Corporation is a direct wholly-owned subsidiary of Verizon Communications, Inc., a publicly traded company. Bell Atlantic Communications, Inc. (BACI), NYNEX Long Distance Company (NYNEX LD) and Verizon Select Services, Inc. (VSSI) are authorized interexchange carriers (IXCs) in the State and are wholly-owned (directly or indirectly) subsidiaries of Verizon Communications. BACI, NYNEX Long Distance and VSSI provide both interstate and intrastate long distance services to customers in Maine and VSSI also provides intrastate private lines and other services in the State. The FairPoint Classic companies are authorized to provide, and are providing, local exchange, exchange access and interexchange services as ILECs in each of their respective exchanges in Maine. Each company is a subsidiary of FairPoint, a publicly traded company.

The proposed Transaction is designed to establish a separate, intermediate entity as the holding company for Verizon's local exchange, long distance and related business activities in Maine, New Hampshire and Vermont (Northern New England Spinco Inc. (Spinco)), distribute the stock of that new entity to Verizon shareholders (the spin-off) and immediately merge it with and into FairPoint (the merger). Following the proposed Transaction, Telco will be an authorized ILEC for purposes of providing telephone services (including local exchange, exchange access and intrastate interexchange services) in Maine and Newco will be an authorized IXC in Maine. Current customers of Verizon will become customers of Telco and current customers of BACI, NYNEX LD, and VSSI will become customers of Newco. Both Telco and Newco will be direct wholly-owned subsidiaries of FairPoint.

While VSSI will continue to do business in Maine, Verizon New England, NYNEX LD and BACI will no longer have any business in the State. Under the proposed Transaction, NYNEX LD, BACI and VSSI are not seeking to terminate their authorization from the Commission to provide service, but Verizon New England is seeking Commission approval to discontinue service in Maine. Other affiliates of Verizon, not part of the proposed Transaction, will continue to operate in Maine, including Verizon Wireless, Verizon Business Global, LLC and the successors to the former MCI companies.

Following the proposed Transaction, FairPoint will be the surviving company (under its existing name) and will own all of the stock of Spinco, which in turn will own all of the stock of Telco and Newco. Verizon Communications shareholders will own approximately 60% of FairPoint and FairPoint shareholders will own approximately 40%. Current FairPoint management will manage and control the day to day operations of FairPoint.

B. Commission Proceeding

The Commission opened an adjudicatory proceeding "to determine whether the transactions, as proposed, are consistent with the public interest and the interests of the Joint Applicants' ratepayers and investors, and, if not, whether the imposition of specific conditions would protect the public interest as well as the interest of ratepayers and investors such that the transactions can be approved."[2]

The following parties filed timely petitions to intervene and were granted intervention status: the Office of the Public Advocate (OPA); Communication Workers of America (CWA) and International Brotherhood of Electrical Workers (IBEW) Locals 2320, 2326, and 2327, and IBEW System Council T-6 (collectively Labor); the Eastern Maine Labor Council, AFL-CIO[3]; the CLEC Coalition (Mid-Maine Communications, Oxford Networks, and Pine Tree Networks); Biddeford Internet Corporation d/b/a Great Works Internet (GWI); One Communications (One); Cornerstone Communications, LLC;

[2] The transaction proposed by the Joint Applicants requires multiple Commission approvals under both state and federal law, including but not limited to 35-A M.R.S.A. §§ 304, 707, 708, 1101, 1104, 2102, and 2105, as well as 47 U.S.C. § 254(e). *See infra* Section III.

[3] Due to the limited information in the Eastern Maine Labor Council's (Council) petition to intervene regarding how this proceeding would have a direct and substantial impact on it, the Council was granted discretionary intervention pursuant to Section 721 of Chapter 110.

XO Communications Services, Inc.; Level 3 Communications, LLC[4]; the Telephone Association of Maine (TAM); Pine Tree Telephone and Telegraph Company; Saco River Telegraph and Telephone Company; Oxford Telephone Company, Oxford West Telephone Company, Oxford County Telephone Service Company and Revolution Networks, all d/b/a as Oxford Networks; Mid Maine Communications; Lincolnville Telephone Company; Tidewater Telecom, Inc.; Unitel, Inc.; U.S. Cellular Corporation; and the Department of Education and the Maine State Library.

On March 12, the Commission received a late-filed petition to intervene from James D. Cowie,[5] on behalf of the complainants (Complainants) in Docket No. 2006-274, *Request for Commission Investigation Into Whether Verizon Cooperated in Maine with the National Security Agency's (NSA) Warrantless Domestic Wiretapping Program* (*NSA Proceeding*). The Complainants sought to have the Commission condition approval of the proposed Transaction on Verizon's agreement to continue to be subject to the Commission's jurisdiction over claims against Verizon in the *NSA Proceeding* and on FairPoint's agreement not to provide any government agency with unwarranted access to facilities it acquired from Verizon or customer information.

The Hearing Examiner's March 28, 2007 Procedural Order granted discretionary intervention status to the Complainants pursuant to Section 721 of Chapter 110 of the

[4] On July 24, 2007, Level 3 notified the Commission that it was withdrawing its petition to intervene and that it approved the proposed transaction without conditions. The Hearing Examiner granted Level 3's Motion to Withdraw on July 31, 2007.

[5] In 2006, Mr. Cowie initiated a 10-person complaint asking the Commission to investigate news reports that Verizon was participating in the National Security Agency's (NSA) warrantless domestic wiretapping and data collection program. The United States of America brought suit in U.S. District Court, which resulted in a preliminary injunction. *U.S. v. Adams*, CV-06-97-B-W, Order (Feb. 8, 2007). The case has been consolidated with similar cases from other states, and is now pending before the Ninth Circuit Court of Appeals.

Commission's Rules, and pursuant to Section 723, limited their participation to written briefs (or oral argument if allowed by the Commission) regarding the need to, and/or means of, preserving the Commission's jurisdiction over the existing claims against Verizon in Docket No. 2006-274.

On March 23, 2007, the Joint Applicants filed the Direct Testimony of Stephen Smith on behalf of Verizon and Peter Nixon, Walter Leach, Michael Harrington, Michael Haga, and Michael Balhoff on behalf of FairPoint. On July 13, 18, 20 and 24, 2007 the OPA filed the Direct Testimony of Matthew Kahal, David Brevitz, Robert Loube and Barbara Alexander; Labor filed the Direct Testimony of Kenneth Peres and Randy Barber; the CLEC Coalition filed the Direct Testimony of Brian Paul, Robert Souza and Nick Winchester; and GWI filed the Direct Testimony of Fletcher Kittridge.

On August 22, 2007, the Joint Applicants filed the Rebuttal Testimony of Stephen Smith and Ann Morrison on behalf of Verizon, and Michael Balhoff, Michael Haga and Arthur Kurtze, Michael Harrington, Michael Brown and John Smee, William King, Walter Leach, Brian Lippold, Peter Nixon, Douglas Sicker and Michael Skrivan on behalf of FairPoint. Limited Surrebuttal Testimony was permitted and filed on September 28 and October 1, 2007 by the OPA witnesses, the Labor witnesses and Nick Winchester on behalf of the CLEC Coalition.

Extensive discovery was conducted in this case. Technical Conferences occurred in June and August. More than 400 people attended public witness hearings that took place in September in Portland, Bangor, and Fort Kent with additional remote locations in Houlton and Presque Isle. In addition, the Commission has received hundreds of comments (letters, e-mails and faxes) from the public regarding the proposed Transaction. The Commission has included these comments in the public files (which are open for inspection and review) and as part of the Commission's Virtual Case File accessible on the Commission's website.

The Commission conducted evidentiary hearings[6] on October 2-5, and 10, 2007. On October 10, 2007 TAM filed a letter advising the Commission that TAM members had entered a settlement agreement with FairPoint which resolved TAM's issues regarding the proposed transaction. (*See* Section VI(A) *infra.*)

IV. LEGAL STANDARDS

A. Introduction

The proposed Transaction requires multiple Commission approvals under both state and federal law, including but not limited to 35-A M.R.S.A. §§ 304, 707, 708, 1101, 1104, 2102 and 2105, as well as 47 U.S.C. § 254(e). Consideration of the proposed Transaction also requires a discussion of 47 U.S.C. §§ 153, 214(e), 251, 252, 254(e) and 271.

B. Maine Law

1. Reorganizations

The Joint Applicants seek the Commission's approval of their proposed Transaction pursuant to 35-A M.R.S.A. § 708. Section 708(2) requires Commission approval of reorganizations, which, under Section 708(1)(A), include "any creation, organization, . . . merger, transfer of ownership or control, . . . dissolution or termination, direct or indirect, in whole or in part, of an affiliated interest . . . accomplished by the issue, sale, acquisition, lease, exchange, distribution or transfer of

[6] Approximately 580 exhibits were introduced into evidence.

voting securities or property." 35-A M.R.S.A. § 708(1)(A). The Commission may grant such approval only if "it is established by the applicants for approval that the reorganization is consistent with the interests of the utility's ratepayers and investors." 35-A M.R.S.A. § 708(2)(A).

In prior reorganization cases, the Commission has construed the broad "consistent with the interests" language of the statute as articulating a "no harm" standard. That is, the Commission has approved reorganizations where the merging parties have established that the transaction will not adversely affect ratepayers and investors. See *New England Telephone and Telegraph Co. and NYNEX Corporation, Proposed Joint Petition for Reorganization Intended to Effect the Merger With Bell Atlantic Corporation*, Docket No. 96-388, Order Part II at 7-8 (Feb. 6, 1997) (*Bell Atlantic*); see also *Verizon Communications, Inc., and MCI, Inc., Request for Approval of Reorganization and Approval of Agreement of Verizon Communications and MCI, Inc.*, Docket No. 2005-154, Order- Part II at 3 (Dec. 22, 2005); *Northern Utilities, Request for Approval of Reorganization* (Merger and Related Transactions), Docket No. 2000-322, Order at 5 (June 30, 2000) (*Northern*). Thus, a merger should be approved if the total benefits flowing from the merger are equal to or greater than the detriment or risks resulting from the transaction for both ratepayers and shareholders. *Bell Atlantic* at 8; *Northern* at 5.

Section 708 further provides that in granting its approval, the Commission "shall impose such terms, conditions, or requirements as, in its judgment, are necessary to protect the interests of ratepayers." These conditions shall include provisions which assure the following:

1. That the commission has reasonable access to books, records, documents and other information relating to the utility or any of its affiliates…;
2. That the commission has all reasonable powers to detect, identify, review and approve or disapprove all transactions between affiliated interests;
3. That the utility's ability to attract capital on reasonable terms, including the maintenance of a reasonable capital structure, is not impaired;
4. That the ability of the utility to provide safe, reasonable and adequate service is not impaired;
5. That the utility continues to be subject to applicable laws, principles and rules governing the regulation of public utilities;
6. That the utility's credit is not impaired or adversely affected;
7. That reasonable limitations be imposed upon the total level of investment in nonutility business, except that the commission may not approve or disapprove of the nature of the non-utility business;
8. That the commission has reasonable remedial power, including, but not limited to, the power, after notice to the utility and all affiliated entities of the issues to be determined and the opportunity for an adjudicatory proceeding, to order divestiture of or by the utility in the event that divestiture is necessary to protect the interest of the utility, ratepayers or investors. A divestiture order shall provide a reasonable period within which the divestiture shall be completed;

   and
9. That neither ratepayers nor investors are adversely affected by the reorganization.

35-A M.R.S.A. § 708(2)(A).

The Commission does not view the attachment of conditions as a requirement of the statute. *Bell Atlantic* at 14. Although the statute provides that "[t]hese conditions shall include provisions to assure …," the preceding sentence of the statute indicates the Commission has the discretion to attach such conditions as it believes appropriate under the circumstances. *Id*. Where the Commission cannot find the reorganization will be in the interest of ratepayers and shareholders in the absence of conditions, it must impose appropriate conditions if it intends to approve the reorganization. *Id*. The

Commission may also find that the reorganization cannot be approved because there are no conditions sufficient to ensure that ratepayers and shareholders are not harmed. If the Commission were to find that the reorganization is in the interest of ratepayers and shareholders even absent conditions, it does not necessarily follow that it should refrain from imposing conditions if those conditions will more nearly ensure that the Commission's conclusion is correct. *Id*. The burden of proof is on the applicants to make a showing that they meet the statute's requirements. *Id*. (quoting 35-A M.R.S.A. § 708(2) (no reorganization may be approved unless it is established by the applicants that the reorganization is consistent with the interest of ratepayers and investors).

Accordingly, given these legal standards, the Commission must review the evidence presented in this proceeding and determine whether the benefits of the proposed Transaction set forth by the Joint Applicants are at least equal to any likely risks to ensure no harm to ratepayers and shareholders. Furthermore, Section 708 gives the Commission the discretion to impose terms, conditions, or requirements that, in its judgment, are necessary to protect the interests of ratepayers. Thus, in weighing the risks, it is appropriate for the Commission to consider the mitigating effects of any such conditions.

The OPA has suggested that the "consistent with the interests" of ratepayers standard requires further definition. OPA Br. at 8. First, the OPA argues that when considering a reorganization, the Commission must protect the interests that underlie utility regulation, e.g., that the Commission must ensure that the proposed reorganization will result in "safe, reasonable and adequate service and [will] ensure that the rates … are just and reasonable to customers and public utilities." *Id*. (quoting

35-A M.R.S.A. § 101). Furthermore, the OPA asserts that when the Commission considers a reorganization involving telephone companies, the "consistent with the interests" of ratepayers standard should be informed by the policies underlying the telecommunications portions of Title 35-A which the OPA asserts identify ratepayers' interest more particularly. *Id*.

The OPA points to Section 7101, which states that "[i]t is the policy of the State that telephone service must continue to be universally available, especially to the poor, at affordable rates" (35-A M.R.S.A. § 7101(1)), "it is the goal of the State that all Maine's businesses and citizens should have affordable access to an integrated telecommunications infrastructure capable of providing voice, data and image-based services" (Title 35-A M.R.S.A. § 7101(2)) and that "computer-based information services and information networks are important economic and educational resources that should be available to all Maine citizens at affordable rates." (35-A M.R.S.A. § 7101(4)).

The OPA concludes that as the Commission determines whether the proposed Transaction is consistent with the interests of telephone ratepayers, it should approve the Transaction only if the Commission can be sure that the new FairPoint entity will be able to provide adequate, reliable and affordable telecommunications services – both voice and broadband – in all areas of the State. OPA Br. at 9. That is, according to the OPA, if the effect of the Transaction proposed by the Joint Applicants is either to make rates for telecommunications services more expensive, or to reduce the chances that broadband services will be available in remote areas of the State, the Commission must find that the merger, as proposed, is not "consistent with the interests of ratepayers." *Id*. We discuss the OPA's argument in Section VI(C) *infra*.

2. Affiliated Interests

Section 707 of Title 35-A prohibits a public utility from entering into certain arrangements with an affiliate without written approval from the Commission. More specifically, no public utility may extend or receive credit, including the guarantee of debt, or make or receive a loan to or from an affiliated interest or make any contract or arrangement for the furnishing of management, supervision of construction, engineering, accounting, legal, financial or similar services, or for the furnishing of any service or real or personal property other than those enumerated with any affiliated interest until the commission finds that the contract or arrangement is not adverse to the pubic interest and gives the contract or arrangement written approval. 35-A M.R.S.A. § 707.

The Commission has previously approved the provision of services and facilities between each of the FairPoint Classic companies and any of their affiliated interests pursuant to a standard Support Services Agreement (SSA). The Joint Applicants initially requested that the Commission approve the provisioning of services and facilities between Telco and any of its affiliated interests pursuant to the SSA approved in Docket No. 99-685 (Northland and Sidney) and the use of the Cost Allocation Manual (CAM) submitted in that docket. FP Br. Appendix C at C-6.

FairPoint, in its Brief, now seeks our approval for Telco to use Verizon's CAM upon closing as the approved arrangement between Telco and its affiliated interests. *Id*. FairPoint also requests that Telco not be required to submit any written agreements regarding the provision of services for Commission approval under Section 707 for six months following the closing, provided that Telco complies with the Verizon CAM. FP

Br. Appendix E at E-4. Telco will then submit, for Commission approval, all proposed agreements between Telco and its affiliates and its proposed CAM for the future[7] which may consist of a proposed continuation of the Verizon CAM. *Id.* The proposed CAM will include all policies, procedures and agreements governing services provided between and among FairPoint affiliates and assure that the cost of developing the FairPoint systems used to replace the Verizon systems are appropriately allocated to Telco and that adequate compensation is provided to Telco by any other FairPoint affiliates that might use the systems. *Id.*

Accordingly, the Commission must determine whether the Telco's use of the Verizon CAM is in the public interest. *See* Section V(D) *infra.*

3. Authorization of Sale/Transfer of Property

Section 1101 of Title 35-A requires Commission authorization before a public utility may sell, lease, assign, mortgage or otherwise dispose of property that is "necessary or useful in the performance of its duties to the public." 35-A M.R.S.A. § 1101. To grant approval pursuant to Section 1101, the Commission must find the sale to be in the public interest. See *Central Maine Power Co., Divestiture of Generation Assets – Request For Approval of Sale of Generation Assets*, Docket No. 98-058, Corrected Order Part II at 10 (Dec. 21, 1998). The Commission "must approve asset sales 'to protect ratepayers against an imprudent sale by the utility of equipment useful to the public.'" *Id.*

The Joint Applicants have requested Commission authorization for Verizon to sell FairPoint property that is necessary or useful in the performance of Verizon's duties to

[7] FairPoint reserves the right to take the position that there should be a single CAM effective for all three states.

the public. FP Br. Appendix C at C-1, VZ Br. at 2, n. 2. Accordingly, the Commission must authorize the sale of Verizon's property to FairPoint and must find that the sale is in the public interest. *See* Section XII *infra.*

4. Abandonment of Property or Discontinuation of Service

The Joint Applicants have requested Commission authorization for Verizon to discontinue its ILEC regulated intrastate service in Maine as well as the termination of its authority and any authorization to provide such service. FP Br. Appendix C at C-1, VZ Br. at 2, n. 2.

Pursuant to 35-A M.R.S.A. § 1104, "[n]o public utility may abandon all or part of its plant, property or system necessary or useful in the performance of its duties to the public, or discontinue the service which it is providing to the public by the use of such facilities, without first securing the commission's approval." 35-A M.R.S.A. § 1104(1).

The statute further provides that "[i]n granting its approval, the Commission may impose such terms, conditions or requirements as in its judgment are necessary to protect the public interest" and that "[a] public utility abandoning all or part of its plant, property or system or discontinuing service pursuant to authority granted by the commission under this section is deemed to have waived all objections to the terms, conditions or requirements imposed by the commission in that regard." 35-A M.R.S.A. § 1104(2).

In reviewing requests for the sale or transfer of ownership to another utility pursuant to Section 1101 and to simultaneously discontinue service pursuant to Section 1104, the Commission must determine that the terms of the proposed transaction are reasonable for both the purchasing and selling utilities. *Piney Heights Water Company,* *Re: Petition to Abandon Service and Transfer Assets to Piney Heights Water Association*, Docket No. 1991-170, Order at 1 (Sept. 10, 1991). The Commission must also review the reasonableness of the proposed transaction from ratepayers' perspective to determine what effect the transaction will have on rates and quality of service. *Id*.

Section 1104 allows the Commission to attach reasonable conditions to an approval for abandonment or discontinuance of service necessary to protect the public interest. See, e.g., *Verizon New England, Inc. d/b/a Verizon Maine, Request for Waiver to Effect a Transfer of Subscribers*, Docket No. 2001-473, Order at 2, (July 25, 2001); *Edmund J. Quirion, Request to Abandon Service*, Docket No. 96-030, Order at 5 (Jan. 14, 1998). *See* Section XII *infra.*

5. Approval to Furnish Service

Pursuant to 35-A M.R.S.A. § 2102, a public utility may not furnish any services set out in Section 2101 (which includes the operation of telephones) in or to any municipality in or to which another public utility is furnishing or is authorized to furnish a similar service without Commission approval. 35-A M.R.S.A. § 2102 (1). The Commission may condition approval upon the submission of a bond or other financial security if the Commission determines that such a requirement is necessary to ensure that a public utility has the financial ability to meet its obligations under Title 35-A. *Id.* Section 2105 provides that the Commission must declare that the public convenience and necessity require another public utility to provide service in a location where another utility is already authorized to provide or is providing the same or similar service. 35-A M.R.S.A. § 2105(1).

Telco and Newco request that the Commission declare that the public convenience and necessity require that they be allowed to provide service, that the Commission approve furnishing services by Telco for areas served by Verizon and unserved areas of the State and approve furnishing of competitive interexchange (IXC) services by Newco in Maine. FP Br. Appendix C at C-2-C-3.

If the proposed Transaction is approved, that is, if the Commission approves the sale of Verizon's assets to FairPoint and Verizon's discontinuance of service, then the necessary approvals pursuant to Sections 2102 and 2105, authorizing Telco and Newco to provide service, will likely be given, though they may be subject to certain financial conditions.

6. Filing Schedules of Rates, Terms and Conditions

Pursuant to 35-A M.R.S.A. § 304, every public utility must file schedules of all rates, tolls and charges which the utility has established and which are in force at the time for any service performed by it within the State or for any service in connection with or performed by any public utility controlled or operated by it or in conjunction with it. 35-A M.R.S.A. § 304. Schedules shall include all terms and conditions that in any manner affect rates charged or to be charged by the utility. *Id*. Chapter 214 of the Commission's Rules, "Exemption of Telephone Utilities From Certain Filing and Approval Requirements" (also referred to as the "Detariffing Rule"), which was recently adopted by the Commission, may obviate the need for certain Section 304 filing requirements.[8]

[8] Chapter 214 exempts certain telephone utilities, with respect to certain services, from the filing requirements of Title 35-A M.R.S.A. §§ 304, 307 and 310.

Telco requests that the Commission approve Telco's adoption of Verizon's schedules of its rates, terms and conditions in effect upon commencement of service by Telco as Telco's initial schedule of its rates, terms and conditions and grant any waivers of tariff filing and form requirements of Chapter 120 of the Commission's Rules necessary to facilitate adoption of Verizon's rates. FP. Br. At 72-73 and Appendix C at C-3.[9]

The Joint Applicants also request that the Commission approve Newco's adoption of provisions of applicable tariffs of BACI, NYNEX LD and VSSI and Verizon's simultaneous withdrawal and termination of the applicability of Verizon's schedules. FP Br. Appendix C at C-3. Teleco and Newco plan to file new tariff pages and adopt the existing tariffs of Verizon and Verizon will simultaneously withdraw and terminate the applicability of Verizon's rate schedules. *Id.*

Accordingly, the Commission must approve Telco's adoption of Verizon's rate schedules.

C. Federal Law

1. Eligible Telecommunications Carrier

The Telecommunications Act of 1996 (TelAct) supported universal service by making federal universal service fund (USF) support available to those carriers that are designated as eligible telecommunications carriers (ETCs). Section 214(e)(2) of the TelAct gives state commissions the primary responsibility for designating carriers as ETCs. To be designated as an ETC, a carrier must offer the nine services supported by

[9] Section 7.6(g) of the Merger Agreement, Exhibit 2 to Joint Applications, provides that upon closing Telco must adopt the tariffs of Verizon.

the USF[10] to all customers within the ETC's service area and must advertise the availability and prices of such services using media of general distribution. 47 U.S.C. § 214(e)(1). In addition, as a condition of receiving federal USF support, each year a carrier must certify to the state commission and the FCC that the funds it receives are being used in a manner consistent with the requirements of 47 U.S.C. § 254(e).

Pursuant to 47 U.S.C. § 254(e) and 47 C.F.R. § 54.201(b), the Joint Applicants seek to have the Commission designate Telco as an ETC for the service area previously designated for Verizon. Pursuant to FCC Order on Reconsideration, *In the Matter of Federal-State Joint Board on Universal Service, Ninth Report and Order and 18th Order on Reconsideration*, CC Docket No. 96-45 (FCC 99-306) released November 2, 1999 the Joint Applicants also ask the Commission to certify that Telco will use federal high-cost support in compliance with Section 254(e). *See* Section IX *infra.*

2. <u>FairPoint's Status as a RBOC</u>

For a discussion of FairPoint's status as a Regional Bell Operating Company (RBOC) pursuant to 47 U.S.C. § 153, which impacts the wholesale requirements of Sections 251, 252 and 271 of the TelAct, *see* Section VI(A) *infra*.

3. <u>Wholesale Requirements of the TelAct</u>

For a discussion of the wholesale requirements of Sections 251, 252 and 271 of the TelAct, see Section VI(A) *infra.*

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[10] The Federal Communications Commission (FCC) has defined the services that are to be supported by the federal universal service support mechanisms to include: (1) voice grade access to the public switched network; (2) local usage; (3) Dual Tone Multifrequency (DTMF) signaling or its functional equivalent; (4) single-party service or its functional equivalent; (5) access to emergency services, including 911 and enhanced 911; (6) access to operator services: (7) access to interexchange services; (8) access to directory assistance; and (9) toll limitation for qualifying low-income customers. 47 C.F.R. § 54.101(a).

V. FINANCIAL AND TRANSACTIONAL ISSUES

A. Introduction

In this section we describe the terms of the proposed Transaction as well as the crucial topic of FairPoint's financial integrity following the merger. The terms of the Merger Agreement are complex, but understanding the terms and the overall result of the Transaction is an important element of the evaluation process. This results, in part, from the fact that FairPoint's post-merger financial condition affects virtually every other aspect of the Transaction, as FairPoint's ability to meet its numerous obligations, promises and commitments depends largely on its financial soundness. The reverse is also true. FairPoint's ability to carry out its operational plans and achieve its revenue and expense objectives will play an important role in FairPoint's ability to maintain its financial viability.

In an effort to quantify the going-forward financial structure and intended success of the Transaction, FairPoint provided in discovery the financial modeling tool it used to evaluate its own financial requirements post-merger. Model outputs were provided in Exhibit WL-3, attached to Mr. Leach's Rebuttal Testimony. Not surprisingly, the results of the model as presented by FairPoint indicate a plausible plan for success. However, it is our responsibility to evaluate the basis for FairPoint's optimism. In addition, we must examine the positions of the other parties and their proffered evidence in light of their considerable skepticism of FairPoint's financial projections.

The OPA and Labor are united in their opposition to the Transaction as proposed. The common thread in their arguments is that the financial integrity of the "new" FairPoint will be severely compromised under the current reorganization proposal. The OPA presented three witnesses to address the structure of the Transaction and the post-transaction financial projections of the "new" FairPoint; Dr. Robert Loube and Mr. David Brevitz identified short-comings in both the revenue and expense assumptions used by FairPoint's financial model. They believe the concerns they have identified are substantial enough to warrant outright rejection of the proposed Transaction unless a number of strict and specific conditions being imposed by the Commission. We will discuss those concerns in greater detail below. Mr. Matthew Kahal addresses the topic of FairPoint's financial health before and after the Transaction, on behalf of OPA, with a primary focus on the Company's projected cash flow statements and balance sheets. Mr. Kahal discusses FairPoint's post-closing capital structure and expected credit rating along with the future implications of FairPoint's financing decisions, assuming the projections provided by FairPoint proved to be accurate. Mr. Kahal, along with Dr. Loube and Mr. Brevitz, recommends that the Commission approve the transaction only after imposing a number of specific conditions.[11]

Labor sponsored the testimony of Mr. Randy Barber. Mr. Barber spent considerable time evaluating the financial and transactional issues in the case, including FairPoint's financial projections. Mr. Barber echoes the concerns highlighted by the OPA regarding perceived flaws in FairPoint's financial model, including its many projections, primarily in the area of operating expenses. At the highest level, Mr. Barber believes that the degree to which the new FairPoint will be financially compromised due to its substantial debt-load and resultant increase in capital costs will have

[11] We discuss all of the financial/transactional conditions proposed by the OPA and Labor further below.

repercussions across the FairPoint network, its employees, ratepayers and the economy of the State(s) as well. Mr. Barber testified that FairPoint is banking on the fact that all assumptions in its financial model are accurate in magnitude and in timing and that operational "cutover" occurs flawlessly. Barber Dir., St. 2 at 17. According to Mr. Barber, everything would have to go exactly as FairPoint has planned for its projections to prove accurate, and, in light of FairPoint's lack of experience with transactions of this magnitude, Mr. Barber believes that this is an unlikely scenario. Barber Dir. St. 2 at 8, 11. *See also* Brevitz Dir. at 18-19.

The Examiners share the view that conditions of the type advocated by the OPA and Labor would be critical were the Commission to entertain approval of the proposed Transaction. Indeed, without many of these conditions, the Examiners believe that ratepayers would be harmed by the Transaction. However, a more important question plagues us as well, i.e., does there exist *any* combination of conditions which would adequately insulate Maine ratepayers from a transaction that transfers the majority of the State's public switched telephone network from a utility with solid investment-grade credit ratings to a utility that is expected to fall within the speculative-grade rating category?

B. Terms of the Transaction

1. Overview[12]

On January 15, 2007, Verizon Communications Inc., FairPoint Communications, Inc., and a wholly-owned subsidiary of Verizon known as Spinco entered into an Agreement and Plan of Merger (Transaction) in order to effectuate a transfer of certain

[12] A detailed description of the Transaction can be found in Appendix 1.

Verizon properties, including all of its incumbent local exchange carrier (ILEC) operations in northern New England (NNE) to FairPoint. On the same date, Verizon and Spinco entered into a Distribution Agreement that would facilitate the Transaction by having Spinco become the legal entity which would hold all of the assets, liabilities and other business operations as well as customer relationships that would eventually be transferred to FairPoint under the Merger Agreement.

The mechanics of the proposed Transaction are fairly complex from a tax and legal standpoint, but the end result is relatively straightforward. FairPoint will become the owner and operator of the ILEC operations in Maine, New Hampshire and Vermont, which currently are owned and operated by Verizon. FairPoint will also receive certain other assets, liabilities and business operations, most (but not all) of which are non-regulated currently. Verizon will retain some specified business operations in the three NNE states, which mainly provide a variety of non-ILEC telecommunications services to very large customers. In return, Verizon will receive about $1.7 billion, either in the form of cash or securities that it can use in an exchange for some of its own debt. Plus, Verizon shareholders will become collectively the majority owners of FairPoint, as they will receive about $1.015 billion worth of newly issued FairPoint stock. The total consideration paid by FairPoint equals about $1,800 per access line, which, on an absolute basis, is considerably less than the price of other recent transfers, but the price is not directly comparable to some other sales, which were not consummated under a tax-free structure. To finance the non-stock portion of the transaction, FairPoint will enter into new debt arrangements worth about $2.5 billion.

2. Analsyis

a. Tax Savings

One of Verizon's key objectives in entering into this Transaction was to eliminate or minimize the tax consequences of the spinoff of its NNE properties, similar to what it accomplished with disbursement of its directory publishing operations. OPA Ex. 112 (Super Confidential) Sec. 4(c)(3). It is clear that the price negotiated between Verizon and FairPoint was influenced by the use of the Reverse Morris Trust (RMT) tax mechanism, but quantifying the effect is extremely difficult and not addressed in the record. The use of the RMT structure almost certainly produced a lower price per access line than a taxable transaction would have, but it also may have limited the number of companies that would be able to enter into the transaction with Verizon. A key requirement of the RMT is that shareholders of the "target" company (in this case, Verizon) must become the majority of shareholders of the acquirer surviving corporation (FairPoint). Despite assertions to the contrary by Mr. Smith (Smith Reb. Test. at 14), the number of potential candidates that would be able to enter negotiations involving the type of transaction favored by Verizon probably was limited by the fact that the acquiring corporation (the "survivor") must be considerably smaller than the target company, and the shareholders of the acquiring company collectively must be willing to relinquish majority control of their company to the target company's shareholders.

There may be very good and valid reasons for each party's willingness to enter this type of transaction, but the concern remains that the surviving entity in this instance may not be as strong financially as some other potential buyers who were not able to consummate a deal using the RMT structure. Other potential candidates apparently never entered into anything more than very preliminary discussions with Verizon, as only **BEGIN CONFIDENTIAL ___ **END CONFIDENTIAL** other potential bidder(s) is/are identified in a confidential presentation made to the Verizon Board of Directors. OPA Ex. 112 (Super Conf.) at Sec. 4(c)(3).

b. Lack of Back Office Systems

FairPoint acknowledged that it was aware that it would not receive Verizon's back office systems in the Transaction, and that it would be required to implement and/or acquire such systems, either internally, externally or through some combination of both. Tr. 10/10/07 at 305, 316-317. Presumably, the negotiated price reflected FairPoint's knowledge. It is also quite likely that FairPoint knew it would have to incur substantial costs to purchase the services of Verizon's back office systems for the unknown period of time between closing and the cutover to FairPoint's new systems. Tr. 10/10/07 at 306. The fact that FairPoint was buying "a car without an engine," according to the OPA's description, presumably affected the nominal price of the Transaction, but again, there is no way to quantify that effect.

c. New Bank Financing

No party has asserted that the terms and conditions contained in the new bank financing commitment are unreasonable or out of the ordinary for the type of loan being considered and the credit worthiness of the borrower. The fact that the terms and conditions of Spinco debt securities have not been yet finalized causes some concern, particularly because the interest rate (or the method under which it will be determined) is unknown. The major issue that the parties have with FairPoint's new financing is its relatively large amount, which we will address later, but the parties also raise other possible concerns.

First, the interest rate that FairPoint will incur on the bank loan and on the Spinco securities is one that could cause FairPoint's financial projections to be inaccurate and its financial status to become problematic. The variable rate on the bank loan has the potential to go much higher than the rate estimated in FairPoint's financial model. Conditions in the credit market will determine whether this concern becomes a reality. Although FairPoint asserts that it will use interest rate swaps to mitigate some portion of this threat, it likely cannot eliminate all of it, and swap arrangements themselves come with a price. Also, the rate and all other terms and conditions for the Spinco note have not been established at this relatively late point in the deal. Until we are able to examine all terms and conditions of the Spinco note, we cannot analyze its reasonableness.

The other significant risks associated with all FairPoint's new debt are those related to the refinancing that will be necessary at the time each of the individual instruments matures, since FairPoint's projections call for it to pay down only a relatively small portion (10-15%) of the bank loan and none of the Spinco note by the time each instrument comes due. Even assuming FairPoint is able to execute its business and financial plans as it projects, it will still leave FairPoint's credit rating indicators solidly in the non-investment grade category. As we discuss in our examination of the financial model below, those projections may not be as reliable as we would hope for the task at hand. In any event, FairPoint will be required to refinance a substantial portion of its debt in unknown market conditions with a non-investment grade credit rating. We believe this is more risk than the Commission should allow Maine's largest ILEC to assume.

d. Ownership of the New FairPoint

FairPoint's current shareholders apparently believe it makes sense to give up collective majority control of their company to Verizon's stockholders, most likely because they believe it enhances the long-term growth prospects, and possibly the very survivability, of FairPoint. This Transaction would enhance FairPoint's reputation and recognition by making it the eighth largest telecommunications provider in the United States. Its shares would become more widely held and traded, although it is likely that some current institutional holders of Verizon stock, and possibly some individual shareholders, would be forced or would choose to sell their shares, because FairPoint is currently not included in any of the major market indices. No party has alleged that the issuance of the additional FairPoint shares is unusual or unreasonable, or that it causes any harm to the present holders of either company's shares.

e. Overarching Concerns

The total price of the Transaction and the amount of debt that will burden the post-merger FairPoint cause the Examiners the greatest amount of concern. FairPoint's ability to deal with adverse financial circumstances will be limited by its financial plans, which rely heavily on FairPoint's ability to generate sufficient free cash flow from operations to meet its capital spending, interest, and dividend requirements. Further, FairPoint faces an uncertain future when the time comes to refinance a substantial portion of its debt. We will discuss this situation in greater detail in subsequent sections, but our overarching conclusion is that the Transaction, as proposed, is too risky and approval should only be given if the Commission finds a set of conditions which adequately offset these risks.

C. Fairpoint's Post-Merger Financial Condition And Stability

The ultimate question that must be answered by the Commission in this case is whether FairPoint, after the Transaction, will have the ability to provide safe, reliable and adequate facilities and service and to charge just and reasonable rates for its price–regulated services, as required by Maine statute. The overriding factual question is whether FairPoint has the financial and managerial capability to carry out the transition efficiently and then manage the acquired ILEC operations and various other businesses in an effective and profitable manner, given the increasingly competitive and changing telecommunications market that presently exists.

1. Positions of the Parties

a. FairPoint

FairPoint is currently a fairly small corporation (total assets of about $891 million at September 30, 2007), which owns a group of 30 relatively small local exchange companies (slightly over 300,000 total access line equivalents at 9/30/07) in 18 states. For 2006, it had total revenues of about $270 million and net income of about $31 million. It currently maintains a relatively highly leveraged balance sheet, with about a 3 to 1 debt to equity ratio on its books. It pays an annual dividend of $1.59 per share, which results in an annual cash payout of just over $55 million. Through its current ILEC operations and its financing activities, it has been able to generate sufficient cash flows to meet the "Cash Available for Dividends" criteria contained in its current credit facility, and projects it will continue to do so.

The Transaction proposed by the Joint Applicants would result in FairPoint acquiring from Verizon approximately 1.7 million access line equivalents in the three NNE states at a total cost of about $2.7 billion. In addition, FairPoint will refinance its currently outstanding debt and will likely take on about $200 million more in debt under the delayed draw loan to pay for its new operational support systems and other transition related costs. FairPoint asserts that in spite of the very substantial increase in the total amount of its outstanding debt, its debt to EBITDA (Earnings Before Interest Taxes Depreciation and Amortization) and interest coverage ratios will improve slightly from their present levels. As of the end of September 2007, FairPoint had a debt to EBITDA ratio of about 4.9, based on projected full year results for 2007, and FairPoint's model projects that ratio to be between 4.4 and 4.3 during the projection period (through 2015).

In addition to its assurance that it will comply with its public utility obligations, FairPoint, in order to secure regulatory approval, has made commitments to expand broadband availability on an expedited basis, to continue to provide wholesale, access and interconnection services without interruption at current rates (with some important caveats), terms and conditions (including order processing protocols), and to enhance economic development opportunities within its new service territory. FairPoint has stated its intent to compete vigorously to retain customers and to enhance its revenues by expanding broadband services, to provide many more UNE loops for CLEC customers and, to a lesser degree, to increase its long distance penetration.

FairPoint has also initially committed to add at least 675 jobs in the NNE region (although its work force is projected to decrease over the projection period through attrition of 4% -5% annually as it gains efficiencies and its access lines decrease) and maintain current wage and benefit levels, at least for some period of time. In sum, FairPoint has made some fairly ambitious promises to its many constituents.

FairPoint's financial projections, which are discussed in Section V(D) in greater detail, indicate that FairPoint will generate sufficient cash flows from operations over the first eight years after the merger to: (1) allow it to invest in plant and equipment as will be required (for traditional wireline service) and as it has committed to do (for broadband expansion); (2) continue to pay dividends at the current rate; and (3) make payments to reduce its debt by about 10 – 12% by 2015, although Mr. Leach indicated that FairPoint would not agree to a formal debt reduction commitment, even though it had used that assumption for modeling purposes. Leach Reb. at 32. Instead, FairPoint wants to retain flexibility in the use of its free cash flow. *Id.*

While its loan covenants require only modest amounts (1% quarterly) of principal repayment after the first two years, the term loan is fully repayable on its eighth anniversary of the closing, the revolver (if used) has a term of six years, and the Spinco securities (issued to Verizon) have a term of 10 years. Therefore, between 2014 and 2017, FairPoint will be required to refinance approximately $2 billion in debt instruments, but the availability and terms of the refinancing will depend on prevailing credit market conditions and FairPoint's credit rating at the time.

FairPoint argues that its book capital structure provides little or no basis for evaluating its overall financial condition and viability. Balhoff Reb. at 24-17. Instead, just as its investors and creditors do, FairPoint suggests that the Commission should focus on cash flow and the market valuation of FairPoint's stock to assess FairPoint's ability to carry out the Transaction and live up to its various obligations and commitments. Leach Reb. at 20-22. Mr. Balhoff asserts that almost half of the U.S. corporations with publicly traded debt have non-investment grade ratings. Plus, virtually all non-RBOC telecommunications corporations are rated below investment grade, and therefore, FairPoint's junk bond (or high yield, as preferred by FairPoint) rating should be of little concern to regulators. Balhoff Reb. at 43-45. According to Mr. Balhoff, it is mainly a matter of price, which reflects the interest rate required by lenders. *Id.*

Further, Mr. Leach points out that FairPoint's book owner's equity balance is merely a result of accounting conventions and practices, rather than an indication of financial weakness. Leach Reb. At 19-22. Also, according to Mr. Leach, the Commission can look at FairPoint's stock price to see that investors have and continue to put a positive valuation on FairPoint. *Id.*

b. <u>OPA and Labor</u>

The OPA and Labor have raised serious questions about whether FairPoint has the financial resources and ability to meet its obligations as a public utility, carry out its service improvement and broadband expansion plans, and meet its other stated commitments. Further, as discussed in Section V(C), both the OPA and Labor pose serious questions about FairPoint's financial model, which forms the basis for FairPoint's claims that it can meet its obligations and commitments.

i. <u>OPA</u>

The OPA concludes that the risks associated with FairPoint's highly leveraged capital structure and its high-yield dividend payments are not consistent with the interests of Maine's telephone customers. OPA Brief at 13. The OPA goes on to assert that to the extent FairPoint's projections are not realized, FairPoint will encounter considerable financial hardship. OPA Br. at 14. The OPA further points out that the level of debt proposed in the Transaction will obligate FairPoint to substantial fixed payments of principal and interest. OPA Br. at 14.

The OPA argues that because the interest rate on the Spinco bond issue has not been established, and interest rates for high-yield instruments have recently increased, there is considerable likelihood that FairPoint will end up paying a higher interest rate on all its debt than is assumed in its financial model. OPA Br. at 15. According to the OPA, because one of FairPoint's key financial assumptions concerns the amount and cost of its debt, there is no certainty that FairPoint can maintain its financial viability if the credit markets do not exhibit the assumed characteristics. *Id.* In addition, the payments for debt service, in combination with FairPoint's large dividend payout requirement, required cash payments for operating expenses, taxes and capital expenditures, place too many demands on the projected cash flows to be suitable for a public utility providing essential services. *Id.*

ii. Labor

Labor asserts that FairPoint is a very risky holding company, specializing in acquiring, operating, and selling telecommunications companies. Labor Br. at 8. Fundamental to its financial strategy is the utilization of "free cash flow," derived primarily from depreciation, to pay very high dividends. *Id.* According to Labor, FairPoint is cannibalizing itself by continually paying out more in dividends than it earns. Labor Br. at 10. In the last two years alone, FairPoint has paid dividends equal to nearly twice its level of net income, resulting in its shareholders equity account declining over 21% since its IPO (Initial Public Offering) in early 2005. Labor believes that FairPoint's cannibalization strategy is risky and cannot continue indefinitely. Labor Br. at 8-10.

Labor contends that in order for FairPoint to sustain its approach to business, it must continually acquire new companies and use the depreciation-based cash flows to provide the cash to support its high dividend payments. Labor Br. at 9. Labor argues that with this business model, it is imperative to restrain capital expenditures, since they compete with debt reduction, additional acquisitions, and dividend payments (which are first among equals in competition for corporate resources at FairPoint), for the use of cash. *Id*. If FairPoint's projections prove to be overly optimistic and its results 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 all of these. The impact of such actions is likely to be devastating to Maine. *Id*.

Labor also points out that FairPoint continually pays out far more in dividends than it earns in net income. Labor Brief at 10-11. For the past two years (its first two as a publicly traded corporation), FairPoint has paid out 122% and 178% of net income. In its projections, FairPoint forecasts that from 2009 through 2015 its dividend payout ratio will be between 200% and 300% of net income. *Id.* This may lead FairPoint's distributions to its shareholders to not qualify for treatment as dividends under the Tax Code or Delaware corporation laws, where FairPoint is incorporated.

According to Labor, FairPoint's dividend policy is troubling because, while the needs in the NNE states are great, FairPoint's commitment is paltry. Labor Br. at 11.

After the first year post-closing, FairPoint’s projected level of capital investment is substantially less than Verizon’s current level of capital expenditures. Labor asserts that during the past five years, Verizon NNE capital spending has ranged between $182 million and $228 million per year. In contrast, FairPoint is projecting capital expenditures from 2009 through 2015 of only **BEGIN CONFIDENTIAL** ________________________________ **END CONFIDENTIAL**. FairPoint could use its cash flow to enhance service quality in NNE, but instead, it has chosen to send the money out of the region to its stockholders. Because of the extraordinary debt burden being undertaken by FairPoint, it is not clear that FairPoint could significantly increase its capital spending without being in default on its loans. FairPoint’s loan commitment letter contains a restriction on the level of capital expenditures as a percentage of earnings, although the exact percentage has not yet been established. Labor Br. at 12.

Labor further argues that FairPoint is not a company with a history of stable financial performance, nor is it one that projects stable financial performance going forward. Labor Br. at 13-14. FairPoint’s overly optimistic projections show that its net income will increase slightly, due mainly to decreasing depreciation and amortization expenses caused by under-investment in new plant, but its owner’s equity balance will grow increasingly negative during the term of the projections. *Id*. at 14-15. Mr. Barber concluded that it would not serve the public interest to permit FairPoint to consummate the proposed Transaction, because FairPoint is too small, too inexperienced and too thinly capitalized to undertake a venture of this magnitude. *Id.* at 13-15.

Labor further argues that FairPoint describes itself as an acquisition-minded company, but has never attempted to consummate a deal of this magnitude. Barber

Pub. Dir. at 25. In fact, there are virtually no equivalent instances where the entire three-state operations of an RBOC (with a solid credit investment grade credit rating) were sold to a relatively small firm (with little prospect for improving upon its high yield rating). *Id.* Even more unique is the fact that the smaller acquirer must implement an entirely new set of back office systems. *Id.* The one deal that contains many similar characteristics is the sale of Verizon's Hawaiian Telephone unit (a single state operation) to a private equity firm, which had considerable financial resources but no telecommunications operations experience. The results of that transaction have been very disruptive for customers, and problems persist today, more than 2 years after the transaction closed. Barber Pub. Dir. at 42-44.

3. Recommendation

The parties have raised significant and plausible concerns about FairPoint's ability to meet its regulatory obligations and live up to the various commitments it has made during the proceeding after the Transaction. While FairPoint appears very sincere in, and committed to, its promises, there are major concerns about FairPoint's ability to maintain its financial viability, while keeping the promises it has made to regulators, customers, employees, other telecommunications providers (both competitors and non-competitors), community organizations and other governmental agencies. By necessity, evaluation of nearly every aspect of the proposed Transaction requires an analysis of the financial implications of the area under consideration. The financial state of FairPoint after the Transaction affects all phases of the Company's operations, and the Company's financial model may not present a reliable tool for assessing the risk associated with those operations.

While FairPoint asserts that its dividends are discretionary and, therefore, represent a substantial cash cushion, it is obvious that many things must go as planned for FairPoint to meet its obligations and commitments without incurring financial distress. First and foremost, FairPoint must implement its new back office systems and execute the cutover from Verizon's systems almost flawlessly. While FairPoint and Verizon (working closely with and greatly depending upon Capgemini) have presented a very plausible cutover plan, and FairPoint has agreed to an independent third-party assessment of its pre-cutover testing plans (Liberty Consulting) (see Section VI(C) *infra)*, there will remain some risk of failure or development of significant problems that could disrupt service, or at least, cause major administrative problems for all types of customers. While no one expects anything like the number and magnitude of the problems that plagued and continue to plague Hawaiian Telephone after its sale, the Joint Applicants acknowledge that transferring the back office operations that are as large as those in the NNE states to an entirely new system is an enormously complex undertaking. Correcting any problems that arise could be costly to FairPoint.

Beyond the potential cutover issues, FairPoint will face tremendous operational and financial challenges after the merger, and it appears its options for weathering financial storms are rather limited, due in large measure to its present financial status and corporate financing strategies. Since inception, FairPoint has been a highly leveraged entity, which depends on cash flow from operations to support a fairly high level of debt in its capital structure and, now that its stock is publicly traded, to pay dividends at a relatively high rate (over 10%, per the closing price of November 19, 2007). FairPoint's debt is currently rated as non-investment grade, and its new credit facility most likely will carry a rating that is no better and may be worse than FairPoint's current BB- (by S&P) bond rating. FairPoint's executives profess only cursory interest in attaining investment grade status for their debt after the merger. Leach Reb. at 30-32 and 78).

FairPoint's projections of its highly leveraged capital structure show that at the end of 2008, its book capital structure will contain **BEGIN CONFIDENTIAL** ______________________ **END CONFIDENTIAL**. Within two years after the closing, FairPoint's book owner's equity is projected to be a negative amount (caused basically because dividends will exceed earnings), which will grow larger until it reaches a year-end balance of negative **BEGIN CONFIDENTIAL** ____________ **END CONFIDENTIAL** in 2015. At that point, FairPoint projects that it will have $2.088 billion in debt outstanding, with $1.294 billion due to be refinanced. The remaining $800 million in Spinco bonds will have a maturity of early 2018. As mentioned above, FairPoint's refinancing ability will be highly influenced by credit market conditions and FairPoint's financial condition at the time it attempts to enter the credit market.

Depending on the stock price, FairPoint's market-based capital structure will contain between 60% and 65% debt at closing, but its future market-based capital structure is impossible to predict with any degree of certainty, because of the normal fluctuations that surely will occur in FairPoint's stock price and because of possible changes in the market value of its debt, assuming it becomes publicly traded.

Our analysis leads to the conclusion that, given the terms of the Transaction and the current competitive market conditions and continuing changes in the market for telecommunications services, FairPoint does not have the financial resources or a financial strategy that would provide a sufficient cushion to allow it to overcome any adverse results that might occur between now and 2015. We will discuss below the various conditions proposed by the parties, and we will recommend adoption of specific conditions that address the major shortcomings we find with the proposed Transaction.

D. FairPoint Financial Model Projections

1. Introduction

This section of the Examiners' Report focuses on the flaws and concerns the parties and Examiners have with the financial model used by FairPoint, including the underlying inputs and assumptions used to create the financial projections. We identify a number of high risk assumptions within FairPoint's financial projections that should give the Commission cause for concern and that lead the Examiners to conclude that FairPoint's projections provide neither a sufficiently reliable nor credible basis to allow us to recommend approval of the Transaction as proposed.

2. Background

The financial health of FairPoint post-closing is a critical element of the Transaction that impacts nearly every other issue in the case. In order for the Commission to approve the Transaction, it should have a reliable indicator of FairPoint's viability as the prospective owner of Verizon's Maine operations. This indicator must demonstrate that FairPoint can adequately manage an acquisition that increases its access line equivalents over 6 times from approximately 308,800 to 2,022,100, its revenue over 5 times from $263 million to $1.47 billion, and its debt burden almost 4 times from $602 million to $2.334 billion, while causing no net harm to its ratepayers or shareholders. Leach Reb., Exhibit WL-2 at 15 and 12. To meet its obligation of demonstrating the financial viability of its proposed acquisition, FairPoint prepared a detailed Microsoft Excel-based model that forecasts the projected financial results of the merged company for the period 2007 – 2015. This model forms the basis of FairPoint's position that this Transaction is not only financially viable, but also beneficial to its shareholders and to Verizon's NNE customers alike. FairPoint classified this model as highly confidential. Consequently, its distribution was limited to the Commission (including Advisory and Advocacy Staff), the OPA, and Labor.

FairPoint initially filed the output of its financial model as Confidential Exhibit WEL-1 to the Prefiled Direct Testimony of Walter E. Leach. The actual Microsoft Excel workbook containing an updated version of FairPoint's financial projection was provided in response to discovery. OPA Ex. 8 (Data Request OPA I-10-1 Super Confidential). Along with the model, FairPoint provided the following disclaimer about its use to perform sensitivity analyses:

> Because the file is a working spreadsheet, if any party alters any of the input data or any of the formulas in any of the cells of the spreadsheet, the output data generated by the spreadsheet will be altered. However, results derived from such alterations will not provide reliable scenario analyses unless all related data inputs and formulas are revised to reflect offsetting changes that would reasonably be expected to occur. In many cases, related information is not linked within the spreadsheet to make such offsetting adjustments because the nature or the level of offsetting adjustments requires application of the judgment of the analyst. Because of the size and complexity of the spreadsheet, it is not possible to inventory all such related items.

OPA Ex. 8.

FairPoint distinguished between the two versions of its model by classifying its initial projection as the "Leach/Balhoff" or "Testimony Model" while the updated version is called the "FairPoint Projections: Attachment OPA-I-1-12" or "Discovery Model." Leach Reb. at 23.[13] The results of the Discovery Model were filed as confidential Exhibit WL-3 to Mr. Leach's Prefiled Rebuttal Testimony and are considered the current complete iteration of FairPoint's financial projections. *Id*. at 14.

FairPoint's financial model structure, inputs, assumptions and corresponding outputs became a lightning rod for many of the criticisms raised by the parties over the financial viability of the proposed sale terms and conditions as filed by FairPoint and Verizon. The primary areas of concern raised by the parties, as well as differences between the Testimony and Discovery Models, are discussed below. The question that must be answered by our analysis of FairPoint's financial model and underlying assumptions is whether it produces financial projections that the Commission can rely upon as reasonable representations of the NNE expected financial results under FairPoint's ownership and management.

3. <u>Structure of the Model and the Absence of Sensitivity Analysis Capability</u>

a. <u>Position of the Parties</u>

i. <u>FairPoint</u>

FairPoint states that its financial model was intended to produce a detailed view of the expected financial performance of the combined company based on assumptions that FairPoint's management believed were reasonable. FairPoint asserts that its

[13] FairPoint also prepared two other model scenarios for internal management purposes: Lehman: New Base Case (FairPoint Board Model) and Lehman MAC (MAC Case). *Id*. at 23. Both models were produced by FairPoint's investment banker, Lehman Brothers in conjunction with FairPoint. *Id*. at 23. The MAC Case is a "worst case" scenario prepared for comparative purposes and was requested by FairPoint's Board of Directors. It is not intended to reflect the normal course of business operating results as were the other models. *Id*. at 23.

financial projection model was developed as a tool for capturing and presenting the financial data provided to it by Verizon, and then projecting forward the operating and financial performance of the combined company based on the assumptions FairPoint believed most appropriate. FairPoint acknowledged that the underlying template for the model was produced by Lehman Brothers, but claimed the form and substance of the model evolved substantially over an 18-month period. Leach Reb. at 7.

In response to criticism raised by the OPA, FairPoint asserts that its projection model was never intended to be a model capable of quickly and easily generating multiple scenario analyses for a first-time user. *Id*. at 7-8. FairPoint asserts that its projection model evolved over time as it received relevant information from Verizon and factored that information into the model. FairPoint also asserts that its modeling team, its own analysts and the analysts from Lehman Brothers and Morgan Stanley, know the model well enough that they can confidently run different scenarios by assuring all formulas, pages and tabs are correctly changed as different scenarios are considered. *Id*. at 8. FairPoint concluded that a new third party attempting to make such changes would find it difficult to get comfortable with their results because of the lack of familiarity with the model. *Id*. at 8. Further, despite criticisms raised by the OPA and Labor interveners, both parties were able to generate sensitivity analyses using the FairPoint financial model. FP Br. at 29.

ii. OPA

The OPA opines that the FairPoint financial model is a tool created primarily to persuade FairPoint's Board of Directors to approve the proposed Transaction rather than a tool that objectively determines whether the Transaction is financially viable.

OPA Br. at 31. OPA notes that the FairPoint financial model is based upon numerous hard coded values that are difficult to trace to verifiable sources and are difficult to modify when testing the changes that would result from using different assumptions. OPA Br. at 31; Brevitz Dir. at 79-81; Loube Dir. at 26-28.

iii. Labor

Labor also notes that the model contains a significant number of hard-coded inputs, identifying at least 891 instances of hard-coded numbers from the year 2007 forward. Barber Super Conf. Dir. at 29-31. Labor also points out that the model contains numerous variables that do not produce expected results when changed to perform sensitivity analyses. Barber Super Conf. Dir. at 31.

b. Recommendation

The financial model represents FairPoint's forecasted results for the period 2008-2015 based upon the information available to FairPoint management at the time of the filing. We find that FairPoint's financial model was not constructed to allow users outside of FairPoint to run reliable sensitivity analyses by changing inputs and assumptions within the model nor was it designed to allow outside users to audit the logic of the model without assistance from FairPoint. To gain this level of understanding, the Examiners and parties were required to propound numerous rounds of discovery on the key inputs and assumptions of the financial model as well as extensively question FairPoint's management team during two rounds of technical conferences. Consequently, it became apparent that running alternative scenarios to FairPoint's "as filed" financial projection requires a detailed understanding of the interplay between the model's numerous formula driven and hard coded inputs and the model algorithms that use those inputs to ensure that revised inputs under alternative assumptions produce expected results.

Thus, we find that the model, as filed, is not capable of producing reliable alternative scenarios to that proposed by FairPoint unless the alternative scenarios are limited to straightforward input changes such as access line growth or DSL penetration rates. More complex or robust alternative scenarios require the involvement of FairPoint personnel or consultants to understand the scope of all input values and formula changes required to accurately reflect the impact of assumptions made by an outside user. Therefore, we recommend that the Commission consider carefully any results from alternative scenarios filed by the parties and recognize that such scenarios require factoring in a certain margin of error to account for unknown changes that FairPoint's model managers would make to the company's operations if it were faced with assumptions different than those it has assumed for this Transaction. (*See* discussion below of specific assumptions.)

4. Lack of State-Specific Data and Projections

a. FairPoint's Position

During the course of the proceeding, FairPoint indicated that it did not initially prepare financial projections on a state-specific basis for the Verizon NNE operations because it believed the financial viability of the merged firm could only be evaluated on a consolidated basis. However, in response to concerns raised about the lack of Maine-specific financial information in the record, FairPoint prepared a series of schedules called the Maine Financial Projections covering the period 2008 – 2015. Leach Reb. at Ex. WL-4. FairPoint prepared this projection by separating its consolidated financial projection into the three NNE states individually, plus a holding company account. Leach Reb. at 22. However, FairPoint described this projection as limited in its usefulness and reliability due to the exclusion of certain costs and non-regulated service data that cannot be identified at a state-specific level. *Id*.

b. Recommendation

FairPoint attempted to produce a state-specific financial projection for its prospective Maine operations, but the projection is limited in its usefulness due to the many limitations identified by FairPoint, as well as from others that are apparent from reviewing the Maine Financial Projections. For example, all debt and related interest expenses are excluded because they are assigned to the holding company for projection purposes. Leach Reb. at Ex. WL-4. Additionally, this financial projection was provided in hard copy form only, precluding the parties from performing sensitivity analyses or understanding the basis for the separated results on the underlying Microsoft Excel workbook.

We recommend that the Commission find that FairPoint's Maine Financial Projections are of limited value and should not be used to reach definitive conclusions regarding the impact of this proposed Transaction on Maine ratepayers. Consequently, we recommend that the Commission focus on the consolidated projections filed by FairPoint instead in evaluating the financial viability of this Transaction.

5. Financial Projections – General Critique of Results

a. Position of the Parties

i. FairPoint

FairPoint prepared detailed *pro forma* financial projections as part of its due diligence process in evaluating the merits of acquiring the Verizon NNE assets. Leach Conf. Dir. at 19. The FairPoint Board of Directors considered these projections, among other factors, in establishing a value for the Verizon assets it intends to purchase. *Id*. at 20. Excerpts of key financial metrics from the financial projection model such as access line growth rates, revenue growth rates, operating expense savings, profitability estimates, projected capital expenditures, and projected free cash flow were touted as evidence of the financial soundness of the transaction. Leach Conf. Dir. at 19-39. Complete summaries of key financial data representing the output of the FairPoint financial projection model were included as Confidential Exhibit A to Mr. Leach's Direct Testimony.

While FairPoint's financial projection spans the years 2008 – 2015, its primary focus is on the projections for the period 2008 – 2012 as the most useful for two reasons: (1) it is long enough to discern the financial characteristics of the steady-state post-transaction operations; and (2) it is not so long as to be overly speculative. Leach Dir. at 6. FairPoint projects the following key trends in the Verizon NNE states under its ownership:

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[14] The compounded annual growth rate (CAGR) of any time series data (e.g., revenue, profits, inventories) is the average growth rate over several years accounting for compound growth. For example, suppose an investment grows 10% a year for two years. In the first year, it grows to 110% of its starting value. In the second year, it grows to 121% (= 110% * 110%) of its starting value. Thus an investment that grows 21% over the course of two years grows at a compounded annual growth rate of 10%. Note that this is close to but not equal to the total growth rate divided by the number of years (21% / 2 years = 10.5%); this calculation doesn't take compounding into effect, and can be highly misleading if the number of years is large or the growth rate is high. CAGR = [(the final value / the initial value) $^{(1/t)}$] -1 where *t* is the number of years. See http://www.wikinvest.com/wiki/Compounded_annual_growth_rate_-_CAGR

[15] Defined by FairPoint as Adjusted Pro Forma Combined EBITDA less (1) Interest Expense, (2) Cash Taxes, (3) Cap Ex, and (4) Changes in Net Working Capital. Adjusted EBITDA is defined as EBIDTA plus additions back for non-cash pension and OPEB expenses for all years and one-time operating and transition costs in 2008. Leach Conf. Dir. Test at 32. It is operating cash flow before paying dividends.

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Included in FairPoint's projected Adjusted EBIT is its assumption that the merger will produce cost savings of between $60 and $75 million annually due to elimination of Verizon overhead and regional cost allocations that are greater than the direct cost FairPoint expects to incur to replace the functions currently performed by Verizon. Leach Conf. Dir. at 38.

FairPoint defended its projections through company and outside experts. Comparisons were made to similarly situated guideline companies to demonstrate the conservativeness of FairPoint's projections. FP Br. at 26. *See also* King Reb. at 4-7. FairPoint also opined that companies involved in acquisitions typically prepare conservative projections to investors and equity analysts to avoid the consequences of missing published financial guidance. FP Br. at 27. *See also* Balhoff Reb. at 6.

ii. OPA

OPA avers that FairPoint's financial model and the projected results it produces are not sufficiently reliable for the Commission to use as a basis to ascertain whether the proposed Transaction will result in a financially viable public utility. OPA Br. at 31. *See also* Brevitz Dir. at 95. According to the OPA, because the model inputs are not reasonable, the Commission should reject the financial projection model and its results. OPA Br. at 31. *See also* Loube Dir. at 28. Flaws include unreasonable and unrealistic estimates of the NNE properties' costs and revenues. The OPA urges the Commission to take specific notice of FairPoint's assumptions for subscriber volumes and revenue. OPA Br. at 32. The OPA argues that the weaknesses in FairPoint's financial projection cannot be saved by comparisons with guideline companies. *Id.* at 25. In fact, according to the OPA, the guideline company analysis prepared by FairPoint witness King is overly broad-brush and ignores more granular data available from the same sources relied upon by Mr. King. *Id.* at 25.

iii. Labor

Labor posits that approval of this Transaction would be an extremely risky proposition based on its analysis of FairPoint's financial projections. The Commission would not be able to safeguard the public from the financial distress FairPoint is likely to experience. Barber Conf. Dir. at 2. Comparison of FairPoint's projections to alternative assumptions based upon FairPoint's and Verizon's actual experience in recent years yields a much less optimistic outlook for the merged company than FairPoint's projection. *Id.* at 2. FairPoint's financial projection provides room for only a small margin of error which may prove to be untenable given its past performance in projecting its revenue and expenses. *Id.* at 2.

b. Recommendation

We agree with Labor that FairPoint's financial projections appear to contain a small margin for error if a number of its key assumptions are inaccurate. As noted below in our analysis of key inputs into the financial model and FairPoint's Free Cash Flow, FairPoint will likely be required to use the cash flow cushion it anticipates earmarking for dividends and debt repayment if its assumptions are not as conservative as it claims. If projected access line losses prove to be greater than anticipated or if FairPoint is unable to increase its revenue per customer through sales of vertical services, unanticipated expenses associated with the back office system development and the merger integration could deplete a significant portion of FairPoint's projected Free Cash Flow. Absent a Commission condition restricting dividend payments, FairPoint will have to voluntarily honor its pledge to forego dividend payments to shareholders to redirect Free Cash Flow to its operational needs.

6. Financial Model Assumption – Retail Access Line Losses Offset by DSL, UNE-P and UNE-L Gains

a. Position of the Parties

i. FairPoint

FairPoint defends its assumptions regarding retail access line losses over the projection period through the Rebuttal Testimonies of Messrs. Leach and King. In response to assertions made by OPA witnesses Brevitz and Loube regarding the high probability that FairPoint will experience more significant increases in line losses than in its projection, FairPoint counters that its plan to rapidly deploy broadband services across Maine will allow it to provide the necessary data services to compete successfully against Time Warner. FP Br. at 33-35. FairPoint believes its line loss projections are conservative beginning with a projected **BEGIN SUPER FINANCIAL CONFIDENTIAL** ____ ______________________**END SUPER FINANCIAL CONFIDENTIAL** when compared with the actual losses for Verizon for the period 2005 – 2006 of 5.0% and 5.7%, respectively. Leach Reb. at 11.

FairPoint contends that its access line losses are but one component in the determination of its projected revenue. It expects to generate incremental revenue from value-added services to offset local exchange revenue losses. FP Br. at 35-36. FairPoint avers that its projected increase in revenue per line for the period 2008 -2015 is conservative when compared with the guideline companies. FP. Br. at 36. *See also* King Reb. at 18-20. (*See* discussion below of specific issues with the guideline company analysis performed by FairPoint witness King.)

Mr. Balhoff subjects FairPoint's projected operating income to two different sensitivity analyses while holding capital expenditures constant. One estimates the impact of FairPoint experiencing less improvement in its access line loss percentage by year from its projection. The second estimates the impact of FairPoint experiencing cash operating expense improvements greater than its projection. Balhoff Dir. at 20-21. Despite the possibility of pressure on FairPoint's operating income if line losses are greater than projected, Mr. Balhoff opines that FairPoint's projections are conservative because they do not factor in revenue improvements from the enterprise markets, video services and additional wireless data revenues. *Id*. at 21. Secondly, FairPoint has not factored in any real cost improvements which would improve cash flow. *Id*. at 21. Third, further acquisitions could add to cash flow. *Id*. at 22. Fourth, FairPoint could repurchase stock, which would reduce its dividend payments, or refinance debt, which would reduce its interest payments and debt repayment obligations. *Id*. at 22. Finally, FairPoint can reduce its projected dividend to post-closing stockholders. *Id*.

ii. OPA

The OPA posits, through Mr. Brevitz and Dr. Loube, that FairPoint's access line projections are too optimistic in the face of competitive threats from cable providers and unrealistic DSL, UNE-P and UNE-L growth assumptions. OPA Br. at 35-36. Dr. Loube asserts that FairPoint's residential sales forecast is predicated on increases in UNE-L sales to offset retail access line losses. Loube Dir. at 35. However, the OPA questions this premise because it believes the risks associated with competition in the Maine telephone market from cable providers is significant. *Id*. at 35. When a FairPoint residential customer is lost to a cable provider, that cable provider will not purchase a UNE-Loop from FairPoint to serve that customer. *Id*. at 35-36.

The OPA believes that unless FairPoint aggressively markets a video service, residential line losses are not likely to moderate. *Id.* at 36. However, inclusion of a video offering may increase revenue, but it is likely to increase FairPoint's costs as well. *Id*. at 36-37. Regardless of whether video services would add net revenue to FairPoint's projection, the OPA argues that the failure to explicitly include the impact of video services in the projection makes the projection unrealistic - as video services are key ingredients to any strategy for retaining residential customers in the face of competition from cable providers. *Id*. at. 37. Additionally, a linear regression analysis performed by Dr. Loube indicates that retail lines have actually declined, instead of increasing, as Verizon has increased the number of DSL-capable lines. *Id.* at 37-38. *See also* Ex. RL-10. Consequently, the OPA contends that increasing DSL availability has not been an effective tool in stemming retail line losses. *Id*. at 37-38.

The OPA also argues that projected UNE-P growth assumptions are overstated because UNE-P is no longer required to be offered by ILECs. FairPoint projects UNE-L growth rates of between **BEGIN SUPER FINANCIAL CONFIDENTIAL** ________ ___**END SUPER FINANCIAL CONFIDENTIAL**. However, national UNE-L growth rates have been less than 3% annually. OPA Br. at 36. *See also* Brevitz Dir. at 86.

The OPA further contends that FairPoint's projected DSL take rate is too optimistic based on historical problems in delivering DSL to rural areas in the Verizon NNE properties. FairPoint does not know the extent to which the existing network can support rapid expansion of DSL services. OPA Br. at 35. *See also* Brevitz Dir. at 83-85. OPA points out that FairPoint stated the following in reply to OPA II-10-1 regarding FairPoint's lack of access to detailed plant records until after closing. **BEGIN CONFIDENTIAL** ____

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b. Recommendation

FairPoint's revenue projection is largely dependent on its ability to stem the rate of line loss that Verizon has been experiencing, FairPoint relies on the expansion of DSL capability throughout the NNE properties and its future success in increasing revenue per customer through subscription to additional services such as video and wireless data. We agree with Dr. Loube that in recent years Verizon has experienced the impact of cable competition in Maine, and the success Time Warner Cable has had with its service is likely to put more pressure on FairPoint's revenue than the financial model reflects.

We find the range of Mr. Balhoff's sensitivity analysis on the impact of access line loss on cash flow is too limited. The upper bound of Mr. Balhoff's analysis is limited to line losses being no greater than 1% over the projected rate of decline. Balhoff Dir. at 21. If the actual rate of line loss experienced by FairPoint is 2% higher than projected, instead of 1%, this would equate to additional line losses of at least 10,000 per year on a base of 1,000,000 switched access lines. Using Mr. Balhoff's sensitivity analysis, the impact of an additional 1% loss in lines per year would result in an additional ****BEGIN SUPER FINANCIAL CONFIDENTIAL**** ___________ ****END SUPER FINANCIAL CONFIDENTIAL**** loss in Free Cash Flow, assuming no corresponding reductions were made to operating expenses.[16] While FairPoint would likely take remedial action to offset its decline in revenue from retail line losses, it may have limited flexibility to do so in a competitive market.

We also believe that UNE-P and UNE-L assumptions may be overstated, and DSL take rates may prove to be lower than anticipated or likely to increase more slowly than projected. Additionally, FairPoint's ability to reduce operating expenses may be limited due to commitments to maintain service quality, as well as the fact that many of its costs are not immediately sensitive to changes in the number of its customers. Other contingencies impacting the financial projection assumptions made by FairPoint that are discussed below may also squeeze or eliminate any cash flow cushion projected by

[16] This amount is calculated from the decline in cash flow projected in Mr. Balhoff's sensitivity analysis from a base case of 0% rate of line loss greater than projected to 1% rate of line loss greater than projected. Doubling this impact to 2% should result in the same incremental loss. See Balhoff Dir. at 21.

FairPoint. Therefore, the cash flow cushion relied upon by Mr. Balhoff may not be there when needed.

Accordingly, we recommend that the Commission find that FairPoint's subscriber projections are too optimistic to support a reliable revenue forecast. While FairPoint conservatively forecasts that its retail access lines will be declining consistent with Verizon's current trends, its offsetting gains from DSL services and UNE-P and UNE-L sales are too aggressive to be considered reliable indicators of FairPoint's projected revenue. Additionally, using the sensitivity analysis prepared by Mr. Balhoff, FairPoint could lose much of its projected cash flow cushion if line losses exceed projection without offsetting expense reductions. Such expense reductions will impact service quality unless productivity and process improvements are sufficient to offset the cutback in expenses.

7. Comparison of FairPoint Projections to Guideline Companies

a. Positions of the Parties

i. FairPoint

In FairPoint's rebuttal testimony, Mr. King presents a series of analyses comparing certain metrics from FairPoint's financial projections to actual results achieved by "guideline companies." King Reb. at 4-36. Mr. King defined guideline companies as a term used in the financial and valuation professions to describe comparable companies "…whose operations and/or operating characteristics (e.g., industry, size, product mix, etc.) are deemed reasonably comparable to those of the subject company." *Id.* at 4-5. Mr. King chose companies he considered to be comparable to either FairPoint's legacy operations or the post-acquisition NNE properties. *Id*. at 5. Mr. King chose the following companies for his analysis: Iowa Telecom, Consolidated Communications, Alaska Communications Systems, Citizens Communications, Citizens Communications, CenturyTel, Valor Communications, and Windstream Communications. *Id*. at 5. He concludes that FairPoint's revenue, net income, operating expense, capital expenditure, and operating cash flow margin projections compare favorably to the benchmark metrics of the guideline companies. *Id*. at 6-28.

Supplemental analyses prepared by Mr. King in response to issues raised by the OPA indicate that projected cash operating expenses per line for the NNE properties in 2009, the first year of projected "normalized" operations, are ****BEGIN SUPER FINANCIAL CONFIDENTIAL** ____ **END SUPER FINANCIAL CONFIDENTIAL**** compared with the median observed cash operating expense per line of $388 during first quarter 2007 for the guideline companies. King Sur-Sur. Reb. at 3. Mr. King opines that these results represent a potential opportunity for FairPoint to realize additional cost savings. *Id*. at 3.

Mr. King disagrees with Mr. Brevitz's assumption that Verizon would have already achieved all available significant revenue streams in conjunction with DSL service offerings. *Id*. at 4. He concludes that what is significant to FairPoint, a company with $1.4 billion in revenue, versus what is significant to Verizon, a company with approximately $90 billion in revenue, could be quite different. *Id.* at 4. Mr. King asserts that the primary difference between Mr. Brevitz's calculation of revenue per line for the guideline companies and Mr. King's calculation is the exclusion of revenue for "other" services such as providing wireless broadband service, Direct Broadcast Satellite

("DBS") video service and VoIP services. *Id*. at 6. These are the types of vertical services that FairPoint can offer to its customers in order to realize more revenue per customer. *Id*. at 7.

ii. OPA

The OPA argues that FairPoint cannot conclude that it will outperform the projected revenue assumptions in its financial model for a number of reasons, even if those revenue assumptions show less revenue than is generated by the guideline companies. First, Mr. King compares disaggregated revenue data from FairPoint's financial projection with aggregated total revenue for the guideline companies. OPA Br. at 26. Total company revenue for the guideline companies includes revenue for services that will not be offered by FairPoint in the NNE properties such as fiber transport, directory revenue, and product sales. *Id*. at 27.

Further, according to the OPA, Mr. King's analysis implies that Verizon has left substantial revenue on the table for the NNE properties compared with revenues earned by the guideline companies. OPA argues that this does not seem plausible for a company of Verizon's stature. Consequently, the OPA believes that the available revenue stream would already be reflected in the baseline Verizon financial data. *Id*. at 26.

OPA witness Brevitz disaggregated the guideline company revenues using the same financial reports relied upon by Mr. King. The resulting 2006 revenue per line for local and long distance services for the guideline companies compared with the NNE properties demonstrates that these properties are already near the high end of the range. OPA Br. at 28. *See also* Brevitz Sur. Reb. at Table IV. A similar analysis of access service and USF revenue indicates that the NNE properties are near the bottom of the per line revenue range when compared with the guideline companies. However, there is limited opportunity to increase revenue per line in this category of service due to regulatory caps on rates and proposed reform of the USF mechanism. OPA Br. at 28-29. *See also* Brevitz Sur. Reb. at Table IV.

The OPA also contends that a comparable analysis of data and Internet service revenue indicates that the NNE properties are at the bottom of the range compared with the guideline companies. FairPoint's ability to increase the revenue per line from these services beyond what it has already projected is limited due to the high penetration rates already assumed for DSL service within the financial projection. OPA Br. at 29-30. *See also* Brevitz Sur. Reb. at Table IV and Loube Super Conf. Dir. at 33.

b. Recommendation

Comparing FairPoint's financial projection metrics to actual results achieved by comparable peers to FairPoint in the telecommunications industry provides the Commission with useful benchmarks to evaluate potential outcomes for FairPoint. However, it is difficult to ascertain whether FairPoint can achieve similar revenue per customer increases, or expense per customer decreases, simply by looking at the achievements of the guideline companies. While the guideline companies may be deemed reasonably comparable to those of the post-merger FairPoint, it is not clear whether the markets they serve are as competitive or more competitive than the NNE properties or whether the existing network infrastructure is maintained at a comparable level. These two considerations, at a minimum, will affect FairPoint's ability to expand its DSL footprint and to provide customers the additional vertical services required to boost FairPoint's revenue per subscriber. Without successful achievement of these initial objectives, FairPoint's revenue stream is at risk of significant erosion due to emerging competition.

We recommend that the Commission find that while FairPoint's guideline company analysis provides useful information, it cannot be relied upon as an indicator of FairPoint's potential post-merger results. To achieve its projections, FairPoint must execute its strategy with no significant setbacks before considering the additional revenue it may earn from additional services. Consequently, we recommend that the Commission not give the results of the guideline analyses as much consideration in determining FairPoint's potential performance as FairPoint's own projected results.

8. Financial Model Assumption – Projected Operating Expenses and Cost Savings

a. Positions of the Parties

i. FairPoint

As noted above, included in FairPoint's projected Adjusted Earnings Before Interest and Taxes is its assumption that the merger will produce cost savings of between $60 and $75 million annually due to elimination of Verizon overhead and regional cost allocations that are greater than the direct cost FairPoint expects to incur to replace the functions currently performed by Verizon. Leach Conf. Dir. at 38. Mr. Leach explained the derivation of these cost savings estimates in detail in his Rebuttal Testimony. Leach Reb. at 46-52.

In response to criticisms raised by Labor witness Barber, FairPoint asserts that its projected operating cost savings are not due to traditional synergies between merging companies where redundant functions are eliminated. Instead, these savings accrue from replacement of certain allocated costs with direct costs to replicate the related operational functions. FP Br. at 29.

FairPoint projects relatively flat operating expense levels for the Verizon NNE properties. *Id*. at 30. FairPoint disputes Labor's contention that this assumption is unrealistic given Verizon's recent experience of operating expense growth that exceeds levels assumed by FairPoint. The Company avers that the direct cost portion of Verizon's operating expenses have actually declined steadily in recent years. *Id*. The cost increases cited by Labor are due to: (1) increasing cost allocations to the NNE region from the Verizon organization outside the region; and (2) increases in non-regulated costs. *Id*.

FairPoint considers its labor attrition rate of 4-4.5% reasonable based upon Verizon's recent experience and the productivity increases FairPoint will be forced to achieve to compete for customers. *Id*. at 31.

FairPoint also contends that Mr. Barber's reliance upon total operating expenses in his expense per line analysis distorts FairPoint's expense per line trend because it includes both cash and non-cash expenses such as depreciation and amortization expense. Leach Reb. at 42. Per line non-cash depreciation and amortization is declining at 5.1% CAGR from 2009 to 2015 while per line cash operating expense is increasing at approximately 2% CAGR. *Id*. This results in an increase in operating expenses per line net of the non-cash expense decline of almost 3.5% in 2015 versus 2007. *Id*.

ii. OPA

While FairPoint projects relatively flat operating expenses over the period 2008 – 2015, OPA cites an analysis performed by Labor witness Barber indicating that Verizon's historical annual expense growth rate has been between 6% and 7% for the period 2002 – 2006. OPA Br. at 34. *See also* Barber Pub. Dir. at 23 and Schedule RB-6. Further, according to the OPA, operating expenses for FairPoint's legacy operations increased by 8.1% for the 12 months ending March 31, 2007. *Id.* at 34. *See also* Barber Pub. Dir. at 23. The OPA argues that if FairPoint has understated its projected operating expenses, then its projected synergy-related savings of $60 to $75 million are at risk of being overstated, which would overstate projected free cash flow. *Id*. FairPoint's financial model assumes that the full amount of synergy savings will be achieved. However, in the "Material Adverse Change" scenario run by FairPoint assuming no synergies occur, FairPoint would essentially have no cash left after payment of expenses, taxes, interest and dividends. *Id*. at fn. 83.

The OPA also believes that FairPoint's assumption that its annual labor attrition rate will mirror Verizon's recent experience of 4 – 4.5% per year is unrealistic. OPA Br. at 38.

Further, the OPA argues that FairPoint's operating expense assumptions do not account for contingencies such as the integration risk associated with managing the NNE network. OPA Br. at 40. FairPoint is taking over a large geographic operation that currently is centrally managed with personnel and systems located outside of its area of operation. *Id*. at 40. FairPoint must replace those systems with back office systems and management processes that it must develop for an operation covering three states.

Id. To replace the suite of legacy systems used by Verizon for over 50 years, FairPoint must develop 600 new systems in a period of approximately 10 months. *Id*. at 41. The OPA argues that if problems arise with these new systems, FairPoint may be forced to extend its payments to Verizon for transition service agreement ("TSA") services. Payments for six months of TSA services would be approximately $132.9 million according to FairPoint's Form S-4/A filing with the federal Securities and Exchange Commission (SEC). Twelve months of TSA payments would total approximately $226.9 million. *Id*. An increase of $94 million in TSA expenses would eliminate any merger synergies. *Id*.

iii. Labor

Labor critiques the sensitivity analysis performed by Mr. Balhoff as too limited in its range of possible outcomes with virtually no consideration of operating expenses that exceed FairPoint's optimistic projection. Barber Conf. Dir. at 5. Mr. Barber extended Mr. Balhoff's sensitivity analysis to include scenarios of operating expenses that exceed projection by up to 5% per year instead of being capped at 1% as in Mr. Balhoff's analysis. *Id*. If actual operating expenses exceed projected expenses by 5% per year, free cash flow is reduced by over **BEGIN SUPER FINANCIAL CONFIDENTIAL** ___________ **END SUPER FINANCIAL CONFIDENTIAL** each year which virtually eliminates any projected cushion. *Id*. at 5-6. *See also* RB Conf. Schedule 14. Even an expense increase of only 2% over the projected expenses would result in negative cash flow of approximately **BEGIN SUPER FINANCIAL CONFIDENTIAL** _______ **END SUPER FINANCIAL CONFIDENTIAL**. *Id*. at 9.

Labor also opines that FairPoint's labor attrition assumptions are unreasonable because FairPoint assumes that the work force would decline by as much as 100 people per year. Barber Conf. Dir. at 7. By 2015, FairPoint will end up with work force smaller than it has today while performing numerous functions in house that Verizon provided through affiliated companies. *Id*. at 7. Labor contends that if employment is maintained at 2008 levels, operating expenses would be at least $35 million higher in 2015 than projected using 2008 wage rates. *Id*. at 7-8.

Mr. Barber avers that FairPoint's forecast of total operating expenses is not credible because FairPoint's projected expenses per line increase only slightly in 2009 and then decline over the next few years. *Id*. at 20. *See also* Barber Conf. Dir. at RB Conf. Sched. 21. This contradicts historic trends for both FairPoint and Verizon. *Id*. Mr. Barber also addresses FairPoint's operating expense per line trends using cash operating expenses, which results in annual percentage changes that range from an increase per line expense in 2009 of 2.5% down to a decrease in per line expense of 0.6% in 2015.

b. Recommendation

FairPoint contends that the merger will produce cost savings of between $60 and $75 million annually due to elimination of Verizon overhead and regional cost allocations that are greater than the direct cost FairPoint expects to incur to replace the functions currently performed by Verizon. We believe that FairPoint can achieve some measure of cost synergies in the first year or two post-merger by replacing Verizon's allocated costs with its own direct costs. However, these cost savings are predicated on FairPoint's ability to effectuate a smooth transition to its new back office platform and billing system without undue delay or unexpected cost increases. If cost savings due to synergies is 50% less than projected by FairPoint, cash flow would decline by at least **BEGIN SUPER FINANCIAL CONFIDENTIAL** __________**END SUPER FINANCIAL CONFIDENTIAL** per year after taxes.[17] If FairPoint were forced to extend the term of TSA payments to Verizon to 12 months due to transition problems, as posited by OPA, this would result in a **BEGIN SUPER FINANCIAL CONFIDENTIAL** ____________________ **END SUPER FINANCIAL CONFIDENTIAL**.[18] This could require FairPoint to incur additional debt by drawing on its $200 million Revolving Credit Facility. If FairPoint's operating expenses per line are closer to historical trends due to lower attrition and higher cash operating expenses than projected, FairPoint's recurring cash flow will be constrained even further. We find Mr. Leach's conclusion that total operating expenses are expected to increase by only 3.5% from the period 2007 through 2015 unrealistic without significant unidentified cost reductions, given both Verizon's and FairPoint's recent historical trends of averaging at least 6% in increases in expenses per line per year.

Thus, we recommend that the Commission find FairPoint's operating expense projections are aggressive and overly optimistic. Until FairPoint has successfully

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[17] Calculated by adding 50% of assumed savings of $65 million to tab Detail in the Discovery Model, cells I377 – P377 at OPA Ex. 8.

[18] See OPA Ex. 8, tab Model, cells AJ167-AJ190 for FairPoint's current projection of a **BEGIN SUPER FINANCIAL CONFIDENTIAL** ________________________

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transitioned Verizon's customer and other operational databases to its newly developed back office systems, the Commission should not rely on FairPoint's projected cost savings. Close monitoring of FairPoint's financial results is necessary to identify trends in expenses that may jeopardize its projected cash flow.

9. Financial Model Assumption – Projected Capital Expenditures

a. Positions of the Parties

i. FairPoint

FairPoint describes its capital expenditure plans through Mr. Leach's direct testimony. Leach Dir. at 30-31 and at 48 (Exhibit A – Capital Expenditures & Access Line Detail). FairPoint projected **BEGIN SUPER FINANCIAL CONFIDENTIAL** __________**END SUPER FINANCIAL CONFIDENTIAL** in one-time conversion and **BEGIN SUPER FINANCIAL CONFIDENTIAL**_______ **END SUPER FINANCIAL CONFIDENTIAL** in one-time DSL build-out capital expenditures along with another **BEGIN SUPER FINANCIAL CONFIDENTIAL** _______ **END SUPER FINANCIAL CONFIDENTIAL** in recurring capital expenditures in 2008. Recurring capital expenditures range from **BEGIN SUPER FINANCIAL CONFIDENTIAL** ________**END SUPER FINANCIAL CONFIDENTIAL** in 2009 to **BEGIN SUPER FINANCIAL CONFIDENTIAL** _________**END SUPER FINANCIAL CONFIDENTIAL** in 2015. Per average annual Total Switched Access Lines, recurring capital expenditures should range from **BEGIN SUPER FINANCIAL CONFIDENTIAL** ____ **END SUPER FINANCIAL CONFIDENTIAL** per line in 2008 to **BEGIN SUPER FINANCIAL CONFIDENTIAL** ____ **END SUPER FINANCIAL

CONFIDENTIAL** per line in 2015. Leach Dir. at 48 (Exhibit A – Capital Expenditures & Access Line Detail).

In contrast, Verizon's recent capital expenditures for 2005 and 2006 net of FIOS expenditures were **BEGIN SUPER FINANCIAL CONFIDENTIAL** ___ **END SUPER FINANCIAL CONFIDENTIAL** per line versus FairPoint's average projected investment of **BEGIN SUPER FINANCIAL CONFIDENTIAL** ____ **END SUPER FINANCIAL CONFIDENTIAL** per line from 2008 – 2012. Leach Dir. at 31.

In response to criticism raised by the parties, FairPoint acknowledged that its projected capital expenditures will be less than Verizon's recent capital expenditures on an absolute dollar basis. Leach Reb. at 54. However, FairPoint asserts that it is rational to reduce capital expenditures in a declining access line environment. *Id.* at 54. Additionally, FairPoint's projected recurring capital expenditures for 2008 and 2009 were virtually the same or slightly greater than Verizon's normal course capital expenditure budget for 2007. *Id.* at 54.

Mr. Leach opines that per line capital investment metrics are a more appropriate measure of FairPoint's investment trends. *Id.* at 54. Average annual Total Switched Access Lines should be the denominator in the per line investment calculation because inclusion of UNE-L lines and DSL lines artificially depress per line investment. *Id.* at 55.

FairPoint's projected capital expenditures ("Capex") cannot be compared with historical depreciation expense as it is a non-cash accounting charge. Balhoff Reb. at 21. Comparing Capex to depreciation expense requires a large number of simplifying assumptions. FP Br. at 32. In response to OPA's concerns that FairPoint's Capex projections may not reflect adequate investment to meet service quality objectives, FairPoint asserts that its Capex budget does include the necessary investment to achieve defined service quality objectives, and it is further validated by the due diligence review of Verizon's network facilities performed by FairPoint personnel. FP Br. at 33. *See also* Tr. 10/2/07 at 186-190. While FairPoint's Capex budget was not developed through a "bottoms up" approach, it is based upon Verizon's historical spending levels adjusted to meet anticipated future needs. *Id.*

ii. OPA

The OPA argues that FairPoint's financial model contains insufficient detail to analyze its projected capital expenditures. According to FairPoint's Form S-4A, it "assumed that recurring capital expenditures of the Spinco business following the end of the transition services agreement with Verizon would remain relatively flat or increase slightly on a per-access-line basis, while the overall decrease in access lines would result in declines in capital expenditures over the projection period." *See* Form S-4/A dated July 10, 2007 at 82. All source data for the projected per line capital expenditures are hard coded in the financial model. *See* OPA Ex. 8, Tab: *Run-rate CapEx*, cells I22 – P22.

The OPA claims that FairPoint's financial model is inappropriately based upon Verizon's recent level of capital expenditures. Because Verizon has had recurring service-quality problems during the period covered by those capital expenditures, the OPA argues that the Commission should assume that the model understates the level of expenditures FairPoint would have to make. This is especially true when considering FairPoint's aggressive DSL objectives.

iii. Labor

Labor claims that FairPoint's projected capital expenditures focus almost exclusively on growth as opposed to improving the quality of existing services. Barber Conf. Dir. at 41. Labor witness Barber points out that just 2% of FairPoint's projected capital expenditures per year are earmarked for service improvement while approximately 50% is targeted for growth. *Id.*

b. Recommendation

We do not believe that FairPoint's comparison of its proposed capital expenditures to Verizon's recent level of capital expenditures is a good baseline for the Commission to ascertain whether FairPoint will invest adequately in its network. Given Verizon's history of service quality problems, ascertaining the adequacy of FairPoint's proposed investment requires a thorough review of the condition of Verizon's network plant to identify the investment necessary to cure the source of network performance issues. This may require FairPoint to allocate a greater percentage of its proposed capital investment to routine network maintenance as opposed to its expansion of DSL service if it does not increase total capital expenditures. We are cognizant of the additional strain increased capital investment may cause on FairPoint's cash flow, absent improved cash flow from increased revenue or expense savings. Should the Commission require FairPoint to meet certain investment commitments, the impact on FairPoint's cash flow will need to be evaluated.

We recommend that the Commission find that FairPoint's projected capital investment may understate the amount necessary to improve existing service quality while expanding FairPoint's advanced service offerings.

10. Financial Model Assumption – Projected Cash Flow

a. Positions of the Parties

i. FairPoint

FairPoint avers that it is committed to providing high quality, advanced communications services at competitive prices to the NNE properties. FP Br. at 6-7. *See also* Leach Conf. Dir. at 6. FairPoint acknowledges that generating cash flow in excess of required investment, operations and other obligations is critical to its ability to meet its commitments. *Id.* FairPoint opines that the appropriate measure of its ability to meet these commitments is its projected Free Cash Flow which is defined as:

Pro Forma Combined Earnings Before Interest, Taxes, Depreciation, and Amortization expenses (EBIDTA)[1]

Add:	Pension / OPEB Cash Adjustment for non-cash expenses
Add:	One-time Operating Expense and TSA Expenses
Less:	Interest Expense
Less:	Cash Taxes
Less:	Capital Expenditures (excluding one-time conversion capital expenditures in 2008)
	Change in Net Working Capital
Equals:	**Free Cash Flow**

1 Combined earnings reflect the earnings of FairPoint legacy operations and the northern New England properties.

Leach Conf. Dir. at 32.

FairPoint currently projects Free Cash Flow of ****BEGIN SUPER FINANCIAL CONFIDENTIAL**** _______ ****END SUPER FINANCIAL CONFIDENTIAL**** in 2008 after excluding non-cash and one time expenses and capital expenditures, a peak of ****BEGIN SUPER FINANCIAL CONFIDENTIAL**** _______ ****END SUPER FINANCIAL CONFIDENTIAL**** in 2010 and a low point of ****BEGIN SUPER FINANCIAL CONFIDENTIAL**** _______________****END SUPER FINANCIAL**

CONFIDENTIAL** in 2015.[19] If 2008 were adjusted to reflect the four-month period of projected TSA costs FairPoint expects to incur instead of the five months of cost in the financial model projection, Free Cash Flow would be **BEGIN SUPER FINANCIAL CONFIDENTIAL** _____**END SUPER FINANCIAL CONFIDENTIAL**.[20] Cumulative cash flows of **BEGIN SUPER FINANCIAL CONFIDENTIAL** ____ **END SUPER FINANCIAL CONFIDENTIAL** are expected through 2015 which FairPoint considers a substantial cushion for unexpected cash requirements. The annual dividends of $142 million are considered discretionary and provide additional cushion. Leach Reb. at 25.

In response to parties' claims that FairPoint will not have sufficient capital resources to contend with contingencies that require additional capital, FairPoint cites the testimony of Messrs. King and Balhoff as well as Perry Wheaton who filed on behalf of the Vermont Department of Public Service in the Vermont case for FairPoint's merger application. FP Br. at 26-27. *See also* Leach Reb. at 58. Mr. Balhoff asserts that FairPoint has a number of options it can employ should the need for additional cash flow arise. Dividend payments can be reduced or eliminated if necessary. Stock can be repurchased. Debt can be refinanced. Balhoff Dir. at 22. Mr. Wheaton testified in Vermont that FairPoint's projected level of Free Cash Flow ensures that FairPoint will

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[19] Based on Leach Reb. at 25, Comparison of Cash After Dividends, line FairPoint Projections: Attachment A:DPS:FP.1-86, with dividends of $142 million per year added back to derive Free Cash Flow.

[20] Amount is calculated by adding 2008 Free Cash Flow and **BEGIN SUPER FINANCIAL CONFIDENTIAL** ______ **END SUPER FINANCIAL CONFIDENTIAL** in expected TSA savings from shortening the TSA period to four months from five months. Leach Reb. at 26.

have access to equity and debt capital markets if needed to finance capital expenditures. Leach Reb. at 58.

ii. OPA

According to the OPA, FairPoint's projected cash flow is most materially impacted by FairPoint's:

1. Assumed growth/decline rates for subscriber volumes and revenues;

2. Cash expenses (which exclude depreciation), of which the largest component is labor;

3. Capital expenditures;

4. Interest on debt; and

5. Dividends.

Brevitz Conf. Dir. at 90.

The OPA contends that FairPoint's projected cash flow is inaccurate for a variety of reasons. First, FairPoint projects that its operating expenses per line will increase less than **BEGIN SUPER FINANCIAL CONFIDENTIAL** ___ **END SUPER FINANCIAL CONFIDENTIAL** in any year in the projection period while the historical average increase for the FairPoint legacy operations is over 11% per year. *Id.* at 91-92. If FairPoint's cash operating expenses increase by 9% per year, it will cause a reduction in cash flow of between **BEGIN SUPER FINANCIAL CONFIDENTIAL** __ _____ **END SUPER FINANCIAL CONFIDENTIAL** and **BEGIN SUPER FINANCIAL CONFIDENTIAL** _______ **END SUPER FINANCIAL CONFIDENTIAL** depending upon the year in the projection period between 2008 and 2012. *Id.* at 93. This would cause an increase in long-term debt outstanding and further decrease Shareholders' Equity. *Id.* at 93.

The OPA contends that if capital expenditures for both the FairPoint legacy operations and the NNE operations increase by 10% per year, cash flow is reduced by **BEGIN SUPER FINANCIAL CONFIDENTIAL** _______ **END SUPER FINANCIAL CONFIDENTIAL** to **BEGIN SUPER FINANCIAL CONFIDENTIAL** _______**END SUPER FINANCIAL CONFIDENTIAL** per year between 2008 and 2012. *Id.* at 93. Further, If the UNE-Loop growth rate is closer to Verizon's actual experience than FairPoint's projection, cash flow is reduced by **BEGIN SUPER FINANCIAL CONFIDENTIAL** ______ **END SUPER FINANCIAL CONFIDENTIAL** to **BEGIN SUPER FINANCIAL CONFIDENTIAL** _______**END SUPER FINANCIAL CONFIDENTIAL** per year between 2008 and 2012. *Id.* at 94.

The OPA argues that the cumulative impact of higher operating expenses, higher interest rates, lower UNE growth, and higher capital expenditures occurring at the same time is reduced cash flow of between **BEGIN SUPER FINANCIAL CONFIDENTIAL** ________ **END SUPER FINANCIAL CONFIDENTIAL** and **BEGIN SUPER FINANCIAL CONFIDENTIAL** _______**END SUPER FINANCIAL CONFIDENTIAL** between 2008 and 2012. OPA witness Brevitz opines that these scenarios "illustrate the severe impact on a highly leveraged entity from unfavorable changes in operating expenses, interest rates, unforeseen capital expenditures, and inaccurate projection of UNE growth." Brevitz Dir. at 95.

The OPA also notes that FairPoint's model does not capture the effect of the $12 million it agreed to reimburse Verizon for the additional investment in DSL deployment that Verizon will make. The Company's working capital amount should be reduced by the $12 million. OPA Br. at 38.

b. Recommendation

FairPoint's projected Free Cash Flow is the subject of much debate in this proceeding. As noted previously, FairPoint's ability to generate cash flow in excess of planned investments, operating expenses and other obligations is the key to FairPoint's viability as a provider of reliable telecommunications services in Maine and the other NNE states. The accuracy of FairPoint's cash flow projections is dependent upon the accuracy of the key components that comprise cash flow: revenue, expenses, capital expenditures, debt costs and dividend payments. FairPoint will need to generate and maintain a significant cash flow cushion to protect against contingencies associated with its transition of service to its back office systems, competitive losses, the potential for experienced employees leaving the company, higher than anticipated normal capital expenditures and many other possibilities.

The FairPoint financial projection filed as the Discovery Model is already out of date since it does not reflect known changes in TSA costs or the $12 million reimbursement to Verizon for DSL investment Verizon is making in 2007. (See Section VI (C) *infra* for further discussion of Verizon's $12 million DSL investment.) While these are one-time transition costs for 2008, FairPoint has also failed to include the potential impact of the Commission's pending decision in the suspended AFOR proceeding, Docket No. 2005-155. The Commission could require a rate reduction that would result in reductions to FairPoint's ongoing revenue stream throughout the projection period. The revenue reduction could be as high as $32.4 million. If the initial revenue reduction is $32.4 million and this amount remains constant over the projection period through 2015, FairPoint's Free Cash Flow would decline by approximately **BEGIN SUPER FINANCIAL CONFIDENTIAL** _______**END SUPER FINANCIAL CONFIDENTIAL** in 2008 and by between **BEGIN SUPER FINANCIAL CONFIDENTIAL** _____ ___________**END SUPER FINANCIAL CONFIDENTIAL** through the remaining years in the projection period.[21] If the required revenue reduction is 50% of the $32.4 million or $16.2 million in 2008, the resulting impact on FairPoint's Free Cash Flow would be approximately **BEGIN SUPER FINANCIAL CONFIDENTIAL** _______ **END SUPER FINANCIAL CONFIDENTIAL** in 2008 and between **BEGIN SUPER FINANCIAL CONFIDENTIAL** ____________**END SUPER FINANCIAL CONFIDENTIAL** in the remaining years in the projection period.[22]

We believe that the model's projections are not sufficiently robust to provide the Commission with an accurate projection of FairPoint's cash flows. In order to mitigate this problem, we have recommended that OPA Conditions Nos. 1 and 2 be adopted.

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[21] Calculated by inserting a new row in tab Summary of the Discovery Model, OPA Ex. 8, under the LEC Revenue section, and entering the revenue reduction as a deduction to the LEC revenue sources. This reduction flows through to the income statement where the offsetting reduction in income taxes is applied in all years reflecting net income before taxes instead of a net loss.

[22] *Id.*

11. Financial Model Versions

a. Positions of the Parties

i. FairPoint

FairPoint defends the existence of different versions of its financial model as an expected evolution in the projection process in a transactional environment as more accurate information is assimilated into the models. Leach Reb. at 23. FairPoint asserts that it would be the rare case that a company involved in a merger, acquisition or other significant financial transaction could rely upon a single set of financial projections. *Id.* at 15.

The primary differences between the Testimony Model and the Discovery Model, which FairPoint states is the most current version of its financial projection, are as follows.

1. An increase in Depreciation & Amortization, a non-cash expense, on the projected Income Statement to increase amortization expense related to existing FairPoint customer lists reflecting a higher appraised value than originally thought. This impacted Net Income but not EBIDTA. Leach Reb. at 17.

2. On the projected Balance Sheet, Net Property, Plant & Equipment declined, Long-Term Debt declined, and Total Shareholders' Equity declined significantly from the Testimony Model. Net Property Plant & Equipment declined by $31 million due to an adjustment to expense approximately $30 million in previously capitalized integration costs. *Id.* at 18-19. Long-Term Debt declined by a range of $22 million to $60 million over the projection period due to the opening cash balance being higher than expected. *Id.* at 18-19. This reduced the need for debt financing. Shareholders' Equity declined by $368 million to $404 million over the projection period due to modifications made to the opening balance sheet for the combined business for accounting adjustments associated with a higher Employee Benefit Obligation transferring to the Spinco operations, working capital and other asset balance refinements, and changes to the deferred tax liability. *Id.* at 18-20. None of these opening balance sheet changes impacted FairPoint's operating projections. *Id.* at 20.

FairPoint opines that a negative value for its book equity is not a major concern to the investment community. Instead market value-based equity is a more relevant measure of FairPoint's worth. Leach Reb. at 20-21.

The Discovery Model was completed after the Form S-4 financial schedules were completed for the original filing. The changes noted above did not come to light until the S-4 filing was made with the SEC. *Id*. at 20. FairPoint did not update its financial projection in its subsequent Form S-4/A filings.

ii. OPA

The OPA contends that the FairPoint financial model contains significantly lower Shareholders' Equity balances than the balances included in FairPoint's Form S-4 filing at the SEC. OPA believes that a negative Shareholders' Equity balance is an indication of FairPoint's financial weakness. OPA Br. at 36. Mr. Brevitz asserts that equity balances accumulated from regulated services should not be eliminated without a purpose that is valid and useful to local ratepayers. According to the OPA, the Commission should not consider it to be a valid purpose in the public interest to disperse these equity balances to Verizon in return for excessive debt on FairPoint. Brevitz Dir. at 87.

iii. Labor

Labor is critical of FairPoint's use of multiple projection scenarios. Mr. Barber points out that there at least six financial projection scenarios. Barber Conf. Dir. at 10. Mr. Barber claims that the Merrill Lynch – Verizon Management case reflects steadily declining after-dividend cash flow that is $3 million lower than the Material Adverse Condition version prepared by FairPoint as its worse case scenario. *Id*. Mr. Barber opines that Verizon was in the best position to project the operating and capital expenditures needed to reliably operate the NNE properties. *Id*. Mr. Barber tested the sensitivity of all financial projection scenarios prepared by FairPoint or its advisors. All of the scenarios produce negative after-dividend cash flow with increases in operating expense assumptions of between 1% and 3% depending upon the model scenario. *Id*. at 11.

b. Recommendation

FairPoint has prepared a number of financial projection model scenarios throughout the due diligence and application phases of the Transaction. It is not unusual for a company to prepare numerous iterations of a financial projection as it refines its input assumptions. We do not believe that the existence of at least six scenarios indicates weaknesses or unreliability with FairPoint's financial forecasting ability. Instead, evaluation of the inputs and assumptions of the single model that FairPoint chooses to rely upon, the Discovery Model, should be the focus of Commission's investigation into FairPoint's financial viability. *See* OPA Ex. 8. These inputs and assumptions have been thoroughly examined in this section of this Report.

We recommend that the Commission find that FairPoint's use of multiple model scenarios is not a major concern in this Transaction. Instead, we believe the Commission's focus should be on the reliability of the most current version of the model filed in this proceeding, the Discovery Model.

12. Conclusion

We believe that the Discovery Model, as filed by FairPoint, is not a sufficiently reliable indicator of FairPoint's future financial performance during the projection period, and we recommend that the Commission not rely upon it for financial projection purposes. FairPoint's financial model and assumptions were purportedly constructed to present a conservative view of its financial outlook to FairPoint's Board of Directors and potential investors. To allay concerns regulators, such as this Commission, might have with this conservative outlook, FairPoint management and outside experts have made numerous statements regarding FairPoint's opportunities to earn greater revenue than projected through lower than expected line losses and customers purchasing bundles of vertical services. Concurrently, FairPoint expects to achieve reductions in its operating expenses beyond what it has projected in line with similarly situated peers or guideline companies.

The Commission should not rely upon these speculative claims by FairPoint and its outside experts to improve FairPoint's prospective performance under this Transaction. Instead, it should see the results promised by FairPoint through actual execution of its business plan. Consequently, if the Commission approves the Transaction, it should seriously consider the conditions we recommend within this Report to ensure that the financial and operational risks associated with the Transaction cause no harm to ratepayers or shareholders.

E. Financial Conditions Recommended by the Parties

In this section we outline and discuss the financial conditions proposed by OPA and Labor. Both parties would prefer that approval of the Transaction be denied as opposed to being conditionally approved, primarily due to concerns about the post-closing financial integrity of the "new" FairPoint. However, they each proposed conditions that would be applied only in the event that the Commission decides to approve the Transaction. In its Brief, FairPoint has indicated acceptance of some of the proposed conditions and rejection of others. Verizon has not addressed the proposed financial conditions in its Brief.

1. Conditions Proposed by the OPA

The OPA recommends that the Commission reject the Transaction outright. However, the OPA also stated that the Transaction is "salvageable" and thus could be approved by the Commission if a stringent set of conditions that would fundamentally alter the terms of the deal is imposed. OPA believes that it is imperative for the Commission to impose all 24 of its proposed conditions.[23] Of these 24 conditions, we describe and consider in this section the 12 that pertain directly to the financial integrity of the surviving FairPoint. The remaining 12 conditions are addressed elsewhere in this Report.[24]

OPA No. 1: The Transaction must be restructured to reduce FairPoint's bond debt by $600 million, thereby reducing the associated interest expense and debt leverage levels.

This condition essentially amounts to a $600 million reduction in the sale price paid to Verizon and is intended to reduce the post-closing debt level and future debt

[23] The OPA's Proprietary Brief lists 24 conditions on pages 3 through 7. In this section we address numbers, 1-4, 7, 13-15, and 21-24.

[24] In Appendix E of FairPoint's Brief, FairPoint provided a table that directly addresses the first 23 OPA conditions (number 24 did not appear in OPA's Press Release dated October 11, 2007) as well as those proposed by Labor and the CLECs. Responses to the proposed OPA conditions can be found on pages E-1 through E-4 while responses to Labor conditions are found on pages E-5 through E-7.

service obligations, or more broadly, the *financial risk profile* of the "new" FairPoint going forward. Specifically, the OPA targeted the bond debt because the interest rate is expected to be higher than the rate on the bank loan and has not yet been determined. OPA Br. at 3.

a. Positions of the Parties

i. OPA

The OPA stated that reducing the up-front debt burden of the new FairPoint by $600 million will result in debt leverage ratios[25] that are more consistent with those of companies holding investment-grade credit ratings.[26] OPA Br. at 3. Furthermore, this would improve FairPoint's cash flow, which in turn would allow it to pay down the remaining acquisition debt at a faster rate than currently projected and most likely improve its credit rating. Finally, the OPA notes that this debt reduction would bring the Transaction's valuation of Verizon's NNE properties closer to (though not down to the same level) the valuations realized in similar transactions involving Embarq and Alltel. OPA Br. at 16. Even assuming this level of a price reduction to Verizon, the resulting price would still **BEGIN SUPER CONFIDENTIAL**______________________ ________________. **END SUPER CONFIDENTIAL** OPA Br. at 3

Concerning the debt burden assumed by "spun-off" companies in similar transactions, the OPA pointed to the Sprint/Nextel spin-off creating Embarq Corporation and the Alltel/Valor Communications transaction that created Windstream Corporation.

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[25] The "debt leverage ratio" referred to herein is defined as the Total Debt Outstanding divided by EBITDA (Earnings Before Interest Expense, Income Taxes, Depreciation and Amortization) unless otherwise specified.

[26] "Investment-grade" is defined as "BBB-"or higher from S&P and Fitch and "Baa3" or higher from Moody's. "Speculative-grade" is defined as "BB+" or lower from S&P or Fitch, and Ba1 or lower from Moody's.

OPA witness Brevitz stated that Embarq's net debt to EBITDA ratio was 2.5X (or 2.5 to 1.0) at the end of 2006[27] and was 2.3X at the end of the first quarter of 2007. Brevitz Dir. at 32, lines 8-14. For Windstream, Mr. Brevitz stated that a roughly equivalent ratio, or the "net debt to OIBDA ratio" was recently 3.1X.[28] The financial projections presented by FairPoint as Confidential Exhibit WL-3 to Mr. Leach's Rebuttal Testimony indicate a Total Debt to EBITDA ratio for this Transaction of ****BEGIN SUPER CONFIDENTIAL**** ____ ****END SUPER CONFIDENTIAL**** using 2008 projections and ****BEGIN SUPER CONFIDENTIAL**** ____ ****END SUPER CONFIDENTIAL**** using 2009 projections, which results in a leverage ratio for the new FairPoint that is ****BEGIN CONFIDENTIAL**** ______________ ****END CONFIDENTIAL**** than those of both Embarq and Windstream.[29]

Regarding the benchmarks for achieving investment grade status, the January 17, 2007 Moody's report on FairPoint stated: "that its (meaning FairPoint's) overall adjusted debt leverage (Debt/EBITDA) is expected to decrease to about 4.2X from 4.7X as a result of this transaction."[30] Attachment to OPA-I-1-20.1 at 1-2. Moody's also

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[27] Per the company's website, 2006 was Embarq Corp's first full year of existence. The Examiners checked Embarq's Yahoo! Finance page ("Key Statistics) on November 16, 2007 and found Total Debt for the most recent quarter-end at $5.87 billion and the latest 12-months EBITDA at $2.65 billion, a ratio of 2.2X.

[28] Per the company's website, 2006 was Windstream Corp's first full year of existence. The Examiners checked Windstream's Yahoo! Finance page ("Key Statistics") on November 16, 2007 and found Total Debt for the most recent quarter-end at $5.70 billion and the latest 12-months EBITDA at $1.68 billion, a ratio of 3.4X.

[29] The Debt to EBITDA ratio amounts are calculated using FairPoint's projected Long-Term Debt balances in 2008 and 2009 from page five of Exhibit WL-3 to Leach Reb. Test. and dividing those amounts by Pro Forma EBITDA on page 3 of Ex. WL-3.

[30] Moody's does not indicate what time frame it used to calculate 4.2X and 4.7X and this may account for the difference from the level suggested by Ex. WL-3.

indicates that a Total Debt to EBITDA ratio exceeding 3.5X, falls outside the investment grade range (Baa or "Triple-B") into the Ba ("double-B") range. *Id.,* table at 3.

Interestingly, Verizon's own internal valuation of its NNE wireline business demonstrated a market value that supported a Total Debt to EBITDA ratio of **BEGIN SUPER FINANCIAL CONFIDENTIAL** _____ **END SUPER FINANCIAL CONFIDENTIAL** which is substantially lower than the ** BEGIN SUPER FINANCIAL CONFIDENTIAL ** _____ ** END SUPER FINANCIAL CONFIDENTIAL ** 2008 projected EBITDA value which Verizon ultimately agreed to accept from FairPoint. OPA Ex. 94 HSR Documents, Merrill Lynch Presentation of January 15, 2007, at 13.

ii. FairPoint

FairPoint will not voluntarily agree to OPA No. 1, precisely because it "would constitute an unacceptable renegotiation of the deal." FP Br. at Appendix E-1. FairPoint notes that one of the OPA's own financial witnesses, Mr. Kahal, testified that the Commission's imposition of such a condition is "not practical" for this reason. Kahal Dir. at 26-27. Although Verizon did not comment on this in its Brief, we assume that Verizon concurs with FairPoint's position opposing imposition of this condition.

b. Recommendation

As we will discuss below, several of the proposed financial conditions could end up being either unenforceable or ineffectual because they are reactive rather than proactive. In some cases, the violation of a condition could signify a major financial problem for FairPoint at a point when it is too late to counteract the problem. In such a case, the only cure may be rate increases, which might have been averted with appropriate steps at the outset.

While the Examiners recognize that imposing OPA Condition 1 would indeed be the equivalent of renegotiating the terms of the Transaction, we believe that such a condition, in combination with OPA Condition 2 discussed below, is one of the very few proactive measures the Commission can take to influence FairPoint's future financial viability. We say "influence" here because we are by no means assuming that the Commission can impose any set of conditions that will assure FairPoint's future viability, considering the financial, operational and competitive issues FairPoint faces under the terms of the Transaction as proposed and the industry environment it will encounter.

The Examiners concur with the OPA that the Transaction, in comparison with other recent telecommunications transactions, is too costly for FairPoint in terms of the debt burden it must incur at the outset. *See* OPA Br. at 15-16, 44-47. In addition, we believe that the debt retirement schedule portrayed in FairPoint's projections exposes FairPoint to too many risks in the out-years of the forecast horizon, which extends from 2008 to 2015. This is the case even if we were to accept FairPoint's projections as completely accurate, which as described above, we do not accept. According to the projections filed in Mr. Leach's Rebuttal testimony, FairPoint's projections only envision principal repayments of approximately ****BEGIN SUPER FINANCIAL CONFIDENTIAL**** ________________________ ****END SUPER FINANCIAL CONFIDENTIAL**** leaving a refinancing obligation, and risk, of approximately $2.1 billion by the end of 2015. Leach Reb. Ex. WL-3, Sec. I, at 4; Tr. 10/05/07 at 169.

The risks associated with this Transaction are real. No party can accurately predict what interest rates will be for Treasury Bonds in the 2012 to 2015 time frame, let alone for speculative grade rural LEC (RLEC) companies such as FairPoint. Will the credit markets be as generous in terms of interest rate spreads for speculative grade or high yield debt at that time as they have been in the past? How will the credit markets view highly leveraged RLECs in 2012 to 2015? Given the uncertainties surrounding medium and long-term forecasting of any economic variables and the uncertainties surrounding FairPoint financial projections, the only way to mitigate this risk is to reduce the amount that may have to be refinanced later.

Our calculations, based on Mr. Leach's Rebuttal Exhibit WL-3 and OPA Ex. 8 (Discovery Model), shown in the table below indicate that reducing FairPoint's acquisition debt by $600 million would by itself reduce the Total Debt to EBITDA ratio into the range of **BEGIN SUPER FINANCIAL CONFIDENTIAL** ____ **END SUPER FINANCIAL CONFIDENTIAL** based on 2008 projections and **BEGIN SUPER FINANCIAL CONFIDENTIAL** ____ **END SUPER FINANCIAL CONFIDENTIAL** based on 2009 projections.[31]

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[31] Adjusted Debt is calculated as follows using OPA Ex. 8 (Discovery Model):
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When combined with an adjustment to reflect a $42 million annual reduction in FairPoint's common dividend discussed below (see table below), these leverage ratios fall into the range of ** BEGIN SUPER FINANCIAL CONFIDENTIAL **___ ** END SUPER FINANCIAL CONFIDENTIAL ** and ** BEGIN SUPER FINANCIAL CONFIDENTIAL **____** END SUPER FINANCIAL CONFIDENTIAL ** respectively based on 2008 and 2009 projections.[32] The ** BEGIN SUPER FINANCIAL

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[32] The adjustments required include all adjustments detailed in the prior footnote supporting the $600M reduction in debt principle plus a change in the input assumption for the projected dividends per share. This adjustment is made as follows:

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CONFIDENTIAL **____ ** END SUPER FINANCIAL CONFIDENTIAL ** to ** BEGIN SUPER FINANCIAL CONFIDENTIAL **_____ ** END SUPER FINANCIAL CONFIDENTIAL ** multiples still exceed Verizon's valuation of its wireline business as a whole. In addition, the year 2 (2009) adjusted Debt to EBITDA ratio of ** BEGIN SUPER FINANCIAL CONFIDENTIAL **____ ** END SUPER FINANCIAL CONFIDENTIAL ** is more consistent with those of Embarq and Windstream and also moves into a range consistent with an investment grade rating (less than 3.5X) based on Moody's Total Debt to EBITDA criterion.

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A firm's *total risk profile* is the sum of its *business risk profile* and its *financial risk profile*. If this Transaction moves forward, FairPoint's business risk will be based on the telecommunications market it will enter and be largely out of the Commission's hands. The only influence the Commission can exert on FairPoint's total risk will be on the financial side, and then only if it imposes a debt reduction at the outset. As such, we would support the imposition of OPA Condition 1 on this Transaction, even if it requires renegotiation of the agreement between Verizon and FairPoint.

OPA No. 2: FairPoint must reduce the dividends it pays to its shareholders by specific percentages in the event of certain specified events.

The OPA identified a formula whereby FairPoint's (the parent) common dividends to shareholders would be limited to varying degrees if the NNE properties did not meet current projections of operating expenses, capital expenditures or EBITDA in the future. OPA Br. at 3-4. The purpose of this condition is to ensure that FairPoint uses a portion of its cash otherwise available to pay its common dividend, which FairPoint refers to as the "financial cushion" in this deal, to accomplish one or more of three goals. First, reallocating cash away from common dividends would allow FairPoint to reduce acquisition debt more quickly than it currently anticipates (and perhaps move towards investment-grade status more quickly). Second, these funds could be used to absorb operating expenses that exceeded projected levels. Finally, cash conserved by reducing dividends could be diverted into capital expenditures to meet the target levels established prior to closing.

a. Positions of the Parties

i. OPA

The OPA proposes that if FairPoint's actual operating expenses exceed currently projected levels by 5% (in absolute dollars), that FairPoint be required to reduce its common dividend by the greater of 25% (approximately $35.5 million) [33] or the amount of the operating expense overage, net of the income tax effect.

[33] The projected annual common dividend amount is expected to be approximately $142 million, based on a per-share annual dividend of $1.59 and approximately 88.9 million shares outstanding.

With regard to FairPoint's NNE capital expenditure projections, OPA proposes that for any given year of the projection period that FairPoint's actual capital expenditures fall short of the currently projected amounts by more than 2% (in absolute dollars), then FairPoint would be required to reduce the dividend by the greater of 25% or the amount of capital expenditure shortfall.

The OPA's third criterion triggering a common dividend limitation hinges on whether or not the Commission adopts OPA Condition No. 1 described above, and reduces FairPoint's debt at the outset. If the Commission does not require FairPoint to reduce its debt leverage at closing, then in any year beyond 2008 in which the unadjusted net Debt to EBITDA ratio is greater than 4.5x, OPA proposes requiring FairPoint to reduce the common dividend by 50% (approximately $71 million) with those proceeds being dedicated to retirement of acquisition debt. If the Commission does require FairPoint to reduce its debt leverage at closing, then in any year beyond 2008 in which unadjusted net Debt to EBITDA is greater than 4.0x, the OPA proposes that the common dividend be reduced by 25%, again with the resulting proceeds being dedicated to retirement of acquisition debt.

ii. FairPoint

Although FairPoint characterizes its payment of common dividends as "discretionary" or as a financial "cushion" against any unforeseen negative financial developments, it steadfastly has refused to accept the possibility of a Commission-imposed limitation on the payment of common dividends to its shareholders as proposed by the OPA and Labor. FP Br. at 20. Mr. Leach stated that FairPoint should be able to retain the discretion to use funds as it sees fit. Leach Reb. at 81. Both Mr.

Leach and Mr. Balhoff also noted that FairPoint's business interests are fully aligned with those of its customers and if FairPoint chose to allocate funds to dividends, rather than to maintenance and customer service expenses or to necessary capital improvements, it would be potentially disastrous for it on the revenue side of the equation. Leach Reb at 72 –73; Balhoff Reb at 3.

Rather than accept the OPA's proposal, FairPoint offered to abide by common dividend restrictions that are slightly more stringent than those presently contained as a loan covenant in the current draft of its bank loan agreement. FP Br. at 20. This limitation would prohibit the payment of any common dividends if FairPoint's Total Debt to EBITDA ratio exceeds 5.50 to 1.0 in the first year following closing or if it exceeds 5.25 to 1.0 in any year thereafter. Id. In addition, common dividends would be suspended if the ratio of EBITDA to interest expense fell below 2.25 to 1.0 in any year. *Id*.

b. Recommendation

The Examiners recognize that there is alignment between the interests of ratepayers and FairPoint and that appropriate levels of spending on operations, maintenance, and capital expenditures will be necessary for FairPoint to maintain or improve its service quality, retain customers, and prevent the erosion of revenues. A degradation in customer service or a deterioration of the network, which causes increased service interruptions or which makes it difficult or impossible to provide certain advanced service offerings or "bundles," is something that could cause the irreversible flight of customers to alternative providers such as their local cable company.

However, other than lowering the amount of debt that FairPoint would incur at the outset, as discussed above, a common dividend limitation or reduction at the outset is really the only other meaningful, proactive condition the Commission can impose that would influence FairPoint's future financial viability. While FairPoint has been questioned by the OPA and Labor regarding a post-closing common dividend reduction, FairPoint has stopped short of making such a commitment, other than to point to a dividend-limiting covenant contained in its bank loan agreement. FP Br. at 20. In addition, both Mr. Leach and Mr. Balhoff suggest that a common dividend reduction is a last resort for FairPoint. Mr. Leach uses the term "emergency cushion" to reference the common dividend, while Mr. Balhoff states that a dividend reduction "would only be invoked if the operations became distressed" or "if there is sufficient justification." Leach Dir. at 33; Balhoff Dir. at 13, 22.

The "last resort" mindset is a matter of concern to us because the Commission will likely have a different view than FairPoint as to what constitutes the appropriate "last resort" threshold. FairPoint's stated view is that as long as the Total Debt to EBITDA ratio is less than 5.25 to 1.0 (from year 2 onward), then it will be appropriate to pay common dividends at the current $1.59 per share annually. The Examiners, on the other hand, would be extremely concerned if two to three years after closing FairPoint's Total Debt to EBITDA ratio was as high as the **BEGIN SUPER FINANCIAL CONFIDENTIAL** _________**END SUPER FINANCIAL CONFIDENTIAL** that is currently envisioned by the Company's projections for year 2 (2009) onward. If the Total Debt to EBITDA ratio does not improve steadily over time, we would view that as rather clear evidence that some element of FairPoint's operating plan was failing or was simply inadequate.

Rather than reacting in the wake of some negative event that triggers a dividend reduction as proposed by the OPA, the Examiners support a common dividend reduction in concert with a limitation on the amount of acquisition debt at the outset of the Transaction, as described above in our discussion of OPA Condition 1. In order to improve the financial picture for FairPoint over the 2008 to 2015 forecast horizon, the Examiners recommend an immediate dividend reduction of $42 million, or approximately 30%, of the projected annual common dividend of $142 million with these funds being earmarked for the retirement of debt. We suggest that this dividend reduction should remain in force until FairPoint achieves an investment grade credit rating. *See* discussion of OPA No. 3 below.

We arrived at our recommendation by using the "comparable company" or peer group data from page C-1-13 of FairPoint's July 2, 2007 Form S-4A filing which is reproduced on page 12 of the OPA's Proprietary Brief. This data indicates that the average dividend yield for the peer companies (excluding FairPoint) was in the vicinity of 6.6%. The average 10-day closing price for FairPoint shares for the period October 31, 2007 to November 13, 2007 was $16.71 and a yield of 6.6% is equivalent to an annual dividend of approximately $1.12, or a cut of $0.47 from the current level. At the projected level of 88.9 million shares outstanding, this would reduce the projected total annual common dividend payment to approximately $100 million, and over the 8-year forecast horizon would reduce outstanding debt by an additional **BEGIN SUPERFINANCIAL CONFIDENTIAL** ___________________________**END SUPER

FINANCIAL CONFIDENTIAL** projected by FairPoint.[34] Also, assuming an increased blended interest rate of 7.50% compared with FairPoint's projected effective interest rate, the dividend reduction alone would virtually negate the increased interest expense caused by the interest rate increase.[35] Combined with the $600 million reduction in initial debt recommended under OPA No. 1 *supra*, cumulative interest expense savings would total approximately **BEGIN SUPERFINANCIAL CONFIDENTIAL**_________ **END SUPER FINANCIAL CONFIDENTIAL**.[36]

[34] Based on formula and input changes made to Discovery Model as described in footnotes under condition OPA No. 1 *supra*. Change in per share dividend amount to $1.12 results in total projected debt principle repayment of **BEGIN SUPER FINANCIAL CONFIDENTIAL** _______**END SUPER FINANCIAL CONFIDENTIAL** from 2008 – 2015.

[35] This conclusion is reached by adjusting two inputs in OPA Ex. 8 (Discovery Model). **BEGIN SUPER FINANCIAL CONFIDENTIAL**___________________

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[36] The adjustments required are the same as for the dividend and interest rate adjustment discussed supra plus the previous description of the adjustment to reduce debt principle by $600 million. The projected cumulative interest expense after all three adjustments is **BEGIN SUPER FINANCIAL CONFIDENTIAL** _________________ _________________________________**END SUPER FINANCIAL CONFIDENTIAL** if the blended interest rate is increased to 7.5% without offsetting reductions in the dividend per share rate.

OPA No. 3: FairPoint must take steps under a plan provided to the Commission to increase and maintain its credit rating to a minimum investment-grade rating. Further, FairPoint should agree that, in any future rate case, ratepayers will be held harmless from any extra debt expense that results from less than investment grade bond ratings.

a. Positions of the Parties

i. OPA

This condition is largely self-explanatory and is related to OPA Condition No. 7 described below. Simply stated, the OPA believes that the achievement of an investment grade bond rating will lower FairPoint's future cost of capital (debt and equity). If FairPoint chooses a more aggressive financial policy that hinders its ability to achieve an investment grade bond rating, resulting in a higher cost of capital, this would constitute "harm" to FairPoint's ratepayers that they would presumably not face if Verizon continued to own Verizon Maine. In order for the Transaction to meet the "no harm" standard for approval, ratepayers would need to be held harmless from this effect and thus not pay "extra" for it.

ii. FairPoint

FairPoint does not agree that achieving an investment grade rating is important in allowing it to have access to capital on a reasonable basis and states that there are legitimate business reasons why it is not necessary. FP Br. at 40-41. FairPoint witness Balhoff specifically pointed to "strong and capable service providers such as Alltel, Citizens, Windstream, Consolidated Communications, Iowa Telecom, Cincinnati Bell and Qwest" as examples of companies that do not have investment grade ratings. Balhoff Dir. at 43-45.

Regarding the "hold-harmless" provision of this condition, FairPoint stated that in a future rate proceeding (or any other proceeding where cost of capital is at issue) parties should be free to present whatever view they have at that time and that it is not necessary to "hard-wire" in any particular approach at this time. FP Br. at Appendix E1-E2. FairPoint also noted that focusing on interest rates alone ignores the bigger picture of the overall weighted average cost of capital (WACC) which could be lower with a higher proportion of debt in the capital structure, because debt capital is less costly than equity capital. FP Br. at 39.

b. Recommendation

We view an investment grade bond rating as generally desirable and are concerned that Maine's largest telephone provider would go from being solidly investment grade to solidly speculative grade if this Transaction is consummated. FairPoint has not addressed the fundamental problem associated with its having a speculative grade bond rating, which is that its cost of capital most likely will be higher than it would be if it had an investment grade rating. FairPoint's Mr. Balhoff conceded this point on Cross-Examination. Tr. 10/04/07 at 89. Generally, for two otherwise similar firms, the one with the higher credit rating should have the lower total risk profile and thus should have a lower overall cost of capital.[37] If the Commission approves the Transaction, it is clear that the incoming owner of the majority of the public switched telephone network in Maine will have a lower credit rating and, thus, a higher risk profile

[37] This is true if one believes that credit ratings are an accurate measurement of the total risk profile of a firm, that the rating process is accurate, and that the ratings process is timely.

and also a higher cost of capitl than the outgoing owner. This is one of the ratepayer "harms" that FairPoint must overcome to gain Commission approval.

From the standpoint of identifying an "investment-grade" interest rate level and imputing that interest rate to FairPoint's debt in a future rate proceeding, holding ratepayers harmless from incremental interest costs would be relatively easy. We are familiar with Reuters websites that publish interest rate spreads for utility bonds over comparable maturity Treasury securities by each credit rating category on a daily basis.[38] Therefore, at any point in time, we could determine what the appropriate interest rate would be for a BBB/Baa2 rated corporate or utility issuer.

It is not at all simple, however, to determine the cost of equity differential that exists between an investment grade and a speculative grade firm. As such, we would not recommend that the Commission adopt the OPA's condition because it would be difficult to fully implement it in a future rate proceeding. Even though we agree with the OPA and Labor and prefer to see FairPoint achieve investment grade status, we do not see how the Commission can "require" it to do so, because it may not be possible to enforce this condition if FairPoint fails to meet it. In fact, the Commission could find in a future rate proceeding that the only way for FairPoint to achieve or maintain investment grade status would be for the Commission to grant it a large rate increase, an outcome that is clearly contrary to the intended purpose of the condition.

[38] The web link is: http://bondchannel.bridge.com/publicspreads.cgi?Utilities

OPA No. 4: The Commission should review and approve final debt agreements.

a. Positions of the Parties

i. OPA

The OPA proposes this condition for consideration due to the interest rate risk it says FairPoint is exposed to on both its proposed bond debt and its bank debt. OPA Br. at 19-22. The OPA noted that the bond debt terms, including the final interest rate, will not be known until very near the closing date and that the interest rate spreads over LIBOR or the Prime Rate indexes in the bank loan agreements have also not yet been finalized. FairPoint's financial projections contain interest rate assumptions and, should these prove to be inaccurate, they could have a significant effect on financial results.

ii. FairPoint

FairPoint does not agree to a second round of Commission approvals and proposes to file "near-final drafts one month prior to closing for information purposes only." FP Br. at E-1.

b. Recommendation

In the ordinary course of business, the Commission typically approves utility financing requests using "not-to-exceed" language when addressing uncertain interest rates, principal amounts, or maturity dates. See e.g., *Bangor Hydro-Electric Company, Application for Approval of Issuance of Securities*, Docket No. 2007-319, Order at 2 (Aug. 28, 2007). However, in this case, the sheer size of the borrowing, over $2.5 billion, creates a dilemma for the Commission in that it must approve a loan agreement where a variable that significantly impacts cash flow, the interest rate, is unknown.

According to the OPA, the rate for high-yield or "speculative grade" debt[39] was recently 8.579%, while FairPoint's projections used an interest rate of 7.50%. OPA Br. at 15. This rate differential is greater than 100 basis points (or 1.00%) and on $2.5 billion this amounts to an incremental interest expense increase of more than $25 million annually which we consider to be significant.[40]

Given the Examiners' view that the financial viability of FairPoint is a crucial factor that the Commission must consider before it can approve the Transaction, we recommend that the Commission require FairPoint to file the "near final" loan agreements for Commission review and approval prior to closing. We also recommend that the Commission put FairPoint on notice that any Commission approval would be contingent upon the final financial terms of the loan agreements being substantially similar to what FairPoint has represented them to be. If the interest rate on either debt instrument ultimately is higher than what was represented throughout this case, the Commission should be able to examine updated financial projections reflecting the actual interest rates on the acquisition debt. Thus, we would recommend that the Commission reserve its right to do so and possibly impose additional mitigating conditions if the Commission finds it necessary to do so.

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[39] The term "junk bonds" is also sometimes used to describe high-yield or speculative grade debt.

[40] As a point of reference, a 7.50% interest rate on $2.5 billion in principal amounts to an interest-only payment of $187.5 million annually assuming no amortization of principal during the year.

OPA No. 7: For the next ten years, FairPoint's rates may not reflect higher capital costs based on FairPoint's higher risk level and higher cost of equity. In any future rate case within that ten-year period, ratepayers will be held harmless from capital costs that exceed those of Verizon.

This condition, in principle, resembles OPA condition No. 3, except that this condition specifically mentions cost of equity, Verizon's cost of capital, and limits the time frame to 10 years, whereas OPA Condition 3 focuses primarily on FairPoint's debt cost and does not offer a time limitation. For the same reasons noted above in response to OPA Condition No. 3, FairPoint does not agree.

Recommendation

As was the case regarding OPA condition No. 3 above, we believe that this condition would likely be difficult or impracticable to enforce, and we therefore do not recommend adoption by the Commission. If the Transaction were to proceed, we are not completely clear on whether the OPA meant that FairPoint would not change the cost of capital and return on equity (ROE) that is ultimately decided in *Maine Public Utilities Commission Investigation into a New Alternative Form of Regulation for Verizon Maine*, Docket No. 2005-155, for 10 years, or whether in all future rate cases taking place in the next 10 years that the Commission should act as if it were setting an ROE assuming the risk profile of Verizon Maine rather than "FairPoint Maine." We cannot presently envision how we would make such a determination in the future since Verizon Maine will no longer exists, and Verizon, Inc. (the parent) may be a company with a much different risk profile than it has today.

OPA No. 13: FairPoint should be subject to close financial monitoring by the PUC, including additional special reporting requirements as follows:

- FairPoint shall continue to collect data for, and provide to the PUC, the same state ARMIS reports that Verizon currently provides to the FCC, for a three-year period following close of the transaction. The Commission may consider reduction of that reporting requirement after that time in consultation with the parties to this proceeding;

- In the first calendar year following close of the transaction (2008), FairPoint shall provide quarterly financial information on a "projections vs. actual" basis, at the same level of detail and on the same accounting basis as contained in the financial model in the "Model" worksheet, the "Standalone Drivers" worksheet, and "OpEx Buildup" worksheet.

- In the succeeding two calendar years following close of the transaction (2009 & 2010), FairPoint shall provide semi-annual financial information on a "projections vs. actual" basis, at the same level of detail and on the same accounting basis as contained in the financial model in the "Model" worksheet, the "Standalone Drivers" worksheet, and "OpEx Buildup" worksheet. The Commission may consider reduction of that reporting requirement after that time in consultation with the parties to this proceeding.

FairPoint's Brief states that it would agree to provide the Commission with "Maine-specific financial results," however it is unclear as to whether it was fully aware of what the OPA would be proposing as a reporting requirement. FP Br. at Appendix E-3.

Recommendation

We agree that close monitoring of FairPoint's financial performance during the projection period, but especially within the initial 3 to 5 years after the closing on Transaction, is crucial to the Commission's ability to carry out its regulatory responsibilities. We recommend that the Commission require FairPoint to provide detailed quarterly and annual results, but we would not recommend that the Commission require the submission of ARMIS-like reports if FairPoint is not required to file them with the FCC. FairPoint's reporting requirements to the FCC will depend on its federal regulatory status after the Transaction. *See* Section VIII *infra.* Because that status will likely not be known until after the closing, we recommend that the Commission require FairPoint to provide the Commission with whatever reports it must file with the FCC. If those reports are available electronically, FairPoint should be required to inform the Commission immediately of their availability and provide a URL link (and other link instructions if necessary) directing us to where they may be readily accessed.

FairPoint should also provide the Commission with copies of all reports it must file with the SEC. Because FairPoint's web site currently provides access to its SEC reports, we recommend that the Commission only require FairPoint to inform us when those documents are posted to its Investor Relations page. If an automatic notification service is available, FairPoint shall place the Commission on that service. Should either the FCC or SEC reports not be available electronically, we recommend the Commission require FairPoint provide it with paper copies in a timely fashion after the reports are filed with their respective agencies.

As with all public utilities, FairPoint will be required to file an annual report with the Commission using the form and format periodically directed by the Commission. We recommend that the Commission establish a specific reporting format for FairPoint, as the Commission has done in the past with Verizon. Essentially, the Commission has allowed Verizon to use the FCC Annual Report forms with some additional Maine specific information included. The Commission may seek input from FairPoint regarding the content of the required annual report.

In addition, for the first three calendar years after the closing (the remainder of 2008, then for all of 2009 and 2010), we recommend that the Commission require FairPoint to provide its actual results in the same detail and format as in Exhibit WL-3 attached to Mr. Leach's Rebuttal Testimony, including the information shown in Section II and Section III on a Maine-specific basis. These reports must be filed by April 1 of each year beginning in 2009 for 2008 results. This will allow the Commission to monitor and assess FairPoint's financial performance and condition.

OPA No. 14: FairPoint will not seek any increase in its local rates before 2012. Rates will be immediately reduced to reflect Verizon's current overearnings to be determined in Docket No. 2005-155.

a. Positions of the Parties

i. OPA

The OPA proposes as a condition of approval, that if and when FairPoint "steps into Verizon Maine's shoes" that it must assume the rates that the Commission determines in its final decision in *Maine Public Utilities Commission Investigation into a New Alternative Form of Regulation for Verizon Maine*, Docket No. 2005-155. This is contrary to a position revealed by FairPoint at hearings and in a letter dated October 10, 2007, indicating it expected that if the Transaction was approved, it was entitled to Verizon's *current rates* and not those yet to be determined in Docket No. 2005-155. In addition to requiring that FairPoint assume Verizon's *new* rates if the proposed Transaction is approved, the OPA requests that the Commission further require that such rates remain in place through the end of 2012. OPA Br. at 90.

The OPA is extremely concerned that after the considerable investment of time and expense by all the parties over the course of several years that the resolution of

Docket No. 2005-155, with the end in sight, will be obviated by the proposed Transaction. The OPA contends that any FairPoint claims of "immunity" from a decrease in local exchange rates coming from a decision in Docket No. 2005-155, would by itself constitute an "adverse impact" on ratepayers pursuant to 35-A M.R.S.A. §§ 7101and 7303(2) and would be reason enough to deny the Joint Applicants' petition. OPA Br. at 83, 88-89.

The OPA also points out that FairPoint was well aware that a comprehensive revenue requirements case was in progress when it began negotiations with Verizon. OPA Br. at 85. In addition to being aware that the rate proceeding was in progress, when FairPoint's Mr. Leach was questioned at the hearings about the Examiners' Report's findings in that Docket, he testified that if it became necessary, FairPoint would be able to absorb the resulting revenue reduction without a negative consequences for its dividend payment or for its Maine broadband deployment plan. Tr. 10/03/07 at 133-134; OPA Br. at 87.

The OPA found it ironic that at the same time that FairPoint is claiming that it expects to realize $60 million to $70 million in annual synergy savings across the three NNE states, that only Verizon's current rates, which the Examiners' Report in Docket No. 2005-155 says are too high by $32.4 million, would be an appropriate starting point for itself. OPA Br. at 86. OPA concluded that if Verizon is "overearning" then FairPoint would end up "overearning" to an even greater degree if it assumed Verizon's existing rates rather than the new rates. *Id.*

ii. FairPoint

FairPoint states that it is entitled to Verizon's *current rates* as opposed to any new rates resulting from a Commission decision in Docket No. 2005-155 for several reasons. First, FairPoint claims that because the Commission "would consider the initial rates in the context of its responsibilities to determine whether there is net harm to ratepayers" the Joint Applicants' petition specifically requested that FairPoint, as a new utility, be allowed take over the current rate schedules of the acquired company. FP Br. at 73. Further, FairPoint also noted Section 7.6(g) of the Merger Agreement states that FairPoint must take over Verizon's current rate schedules. *Id*.

As a second justification, FairPoint notes that the Commission has already "found Verizon's basic monthly rates to be reasonable and affordable so as to serve as the benchmark rates for rural telephone companies which receive support from the MUSF." FP Br. at 74. Thirdly, FairPoint believes that "the continuation of the current rates post closing is particularly reasonable, given that such continuation is accompanied by an ongoing investment of $12 million in DSL deployment by Verizon which will benefit ratepayers." *Id*.

It is clear from the discussion in footnote 12 on page 74 of FairPoint's Brief that FairPoint will file Exceptions to the Examiners' Report in Docket No. 2005-155 in support of Verizon's position that no rate reduction is justified. FairPoint also appears to be preparing to argue that the record in Docket No. 2005-155 does not properly consider "whether the distinct cost structure, revenue base, investment plans and legal nature of [new FairPoint] imply a revenue requirement" that could be the same or higher than that which the Examiners found appropriate for Verizon. FP Br. at fn 12.

Apparently, if the Commission decided to order a rate decrease in Docket No. 2005-155, FairPoint will argue that it is a different utility and is entitled to different rates.

b. Recommendation

With respect to initial rates, we believe that the decision is straight-forward: FairPoint should be allowed to adopt Verizon's current rates as its own when the Transaction closes. Beyond that, however, FairPoint came into this Transaction with its "eyes wide-open" and knew the regulatory landscape. It agreed to purchase the Verizon's NNE properties with the understanding that Verizon was in the midst of a proceeding that could change Verizon's rates or any other aspect of the way Verizon is regulated under the Alternate Form of Regulation (AFOR). As such, we assume that this contingency was factored into the purchase price FairPoint agreed to pay Verizon, and if it was not, it certainly should have been.

The AFOR docket is currently in a period of suspension, under the terms of a Stipulation between the OPA and Verizon that was accepted by the Commission, but that suspension will end no later than 180 days (90 if the parties terminate the suspension period) after the closing of the Transaction or on July 31, 2008, whichever comes first. The Commission may extend the suspension period at the request of the parties. The Commission also has reserved the right to re-open the AFOR docket at any time. The suspension period after closing is designed to permit the parties to engage in good faith negotiations of a final stipulation or settlement of the proceeding. The Stipulation also provides that FairPoint, after the closing, may substitute for Verizon as a party in the AFOR proceeding.

The AFOR Stipulation goes on to say:

> During the entire period the stay remains in effect, all present terms and conditions of the current interim Verizon Maine AFOR, including the rules with respect to pricing flexibility and the existing Service Quality Index reporting and enforcement shall remain in effect. Neither the parties nor the Commission shall undertake any changes to the current interim AFOR until the stay is dissolved unless as part of the Commission's Order in the FairPoint merger proceeding.

AFOR Proceeding, Docket No. 2005-155, Stipulation at 4.

In its Order Approving Amended Stipulation in the AFOR proceeding, the Commission stated that it might consider terminating the suspension, after proper notice and appropriate procedures, if it determined that the delay in the AFOR case was too lengthy and, therefore, not in the public interest. Order Approving Amended Stipulation, Docket No. 2005-155 (Oct. 3, 2007) at 15-16. The OPA has now made a recommendation in the present merger case that may fall within the allowed confines of the AFOR Stipulation.

We recommend that the Commission not adopt the OPA's proposed stay-out, and that the Commission adhere to the proposal set forth in the AFOR Stipulation. After the closing on the Transaction, the Commission should allow the parties to attempt to negotiate a final settlement of the AFOR issues (as contemplated by the Stipulation), or if it believes that the negotiation process would be too lengthy or likely to not be productive, the Commission could terminate the suspension and proceed with the AFOR case as it sees fit. The Commission would retain all options for processing the case, which could range from requiring exceptions to the Examiners Report and picking up the case where it left off, to completely abandoning the case as it presently stands and initiating a new proceeding with a new record that examines FairPoint's revenue requirement, service quality and other operational aspects relevant to an AFOR.

There are other outstanding matters to consider in Docket No. 2005-155. Currently, the Examiners' Report only addresses the Phase I revenue requirement issues. Once that is decided, the Phase II issues will need to be addressed. Among those issues will be whether an AFOR will continue or whether a return to traditional Rate-of-Return regulation is preferable. That decision may be influenced by whether the telephone company is Verizon or FairPoint. If it is FairPoint, we believe a "stay-out" period of at least three years or perhaps as many as five years, as suggested by the OPA, might be appropriate. This would allow the FairPoint management team to fully focus on executing the Transaction, the transition, and the cutover and not on other matters such as rate case or AFOR filings. In addition, after a three-year period there would be at least two full years of post transition-year operating history to use as a representative test-year in a new rate case.[41] Accordingly, we recommend that the Commission retain all options it currently has for processing the AFOR case and resume processing that case after the Transaction is consummated, as is contemplated by the AFOR Stipulation. Thus, FairPoint initially would be allowed to adopt Verizon's present rates, but those rates might be altered by future Commission actions, either within the resumed AFOR proceeding or in an entirely new case.

[41] If the Commission opted for the 5-year stay-out, there would be 4 years of post-transition year operating history to consider.

OPA No.15: In any future rate proceeding, FairPoint rates will reflect Yellow Pages directory revenues foregone by FairPoint when it agreed not to compete with Verizon's former directory business for thirty years.

a. Positions of the Parties

i. OPA

The OPA believes that the imputation of Yellow Pages revenue to Verizon (and its potential successor FairPoint) makes sense from a policy standpoint and notes that it has been a common practice for a number of years. OPA Br. at 79-80. In Docket No. 2005-155, the Hearing Examiner recommended a continuation of this policy and imputed $18 million in revenue to Verizon Maine's revenue requirement in that case. If the Commission were to change course simply because it decided to approve the proposed Transaction, the OPA contends that ratepayers would be faced with a "large adverse impact" through the loss of $18 million in annual revenues, which the OPA believes would cost the average ratepayer $3.20 per month. OPA Br. at 80. The OPA also maintains, based on statements made by Verizon's chief witness Stephen Smith, that Verizon may have halted negotiations with FairPoint had FairPoint balked at assuming the non-compete agreement with Idearc, Inc. Tr. 10/04/07 at 284.

ii. FairPoint

At hearings, FairPoint's Mr. Leach stated that FairPoint agreed to assume the Verizon-Idearc non-compete agreement as part of this Transaction and is therefore precluded from entering the directory business. Tr. 10/03/07 at 22. Mr. Leach also agreed with the suggestion by OPA that FairPoint would "vigorously resist having such an imputation being applied to FairPoint in a future rate case." *Id*. FairPoint did not address this issue further in its Brief other than to reiterate that it would not agree to this condition. FP Br. at Appendix E-3.

b. Recommendation

The issue of imputing revenues from Yellow Pages advertising is one of the more highly contentious elements in the Verizon AFOR case. As part of the case, Verizon, AARP and OPA stipulated that the Commission could continue to analyze the Yellow Pages revenue imputation issue from a regulatory policy perspective and ignore, at least for the present AFOR case, the fact that Verizon has spun off its directory publishing business to its shareholders and, therefore, no longer owns or operates the publishing business. The treatment of the issue in future rate cases was not addressed in the Stipulation. The Examiner in the AFOR case found that $18 million, the amount recommended by AARP, should be imputed to Verizon's LEC operation in Maine to reflect a continuing contribution from Yellow Pages advertising revenue. The Examiner based his recommendation on the fact that directories are a fundamental function of ILECs, and that directories consist of both white and yellow pages, with the latter having the potential to generate additional revenue from advertising that should be used to meet the ILECs overall revenue requirement. The Examiner's Report contained an extensive discussion of the legal and policy basis for continuing to impute revenues from Yellow Pages despite changes in the competitive landscape for directories. Examiners' Report, Docket No. 2005-155, at 117 – 157.

As part of the Transaction, it appears that Verizon required FairPoint to enter into a 30-year non-compete agreement with Idearc, Inc., the new name for Verizon's former publishing business, which was spun off to Verizon's shareholders and is now an independent entity. Tr. 10/04/07 at 284. The non-compete agreement had been a part of the Idearc spin-off arrangement, and Verizon was obligated to "require" any buyer of its NNE operations to enter into a similar agreement. Verizon asserts that it would not have entered into the Transaction without FairPoint's agreement to sign the non-compete agreement. Pub. Tr. 10/04/07 at 283.

We have no direct knowledge of Verizon's motivation for entering the non-compete agreement, but it is plausible that it wanted to ensure that IDEARC would have no competition from Verizon's ILEC operations (or any ILEC affiliate), who might possess a significant marketing advantage because of its name recognition. If Verizon wanted to continue that advantage for IDEARC as part of the Transaction, we believe the other party (FairPoint) should have been appropriately compensated. We have no evidence that such compensation is included in the overall deal.

In the AFOR case, the Examiner raised the possibility that any successor to Verizon may also have Yellow Pages revenues imputed to its revenue requirement in a future proceeding, for the same reasons that the Examiner found that such revenue should be imputed to Verizon in the present AFOR case. While the AFOR Examiners' Report has not been deliberated by the Commission, we recommend that the Commission adopt the position of the Examiner in that proceeding that it is not precluded from making a Yellow Pages contribution imputation in any future rate case involving FairPoint as the successor to Verizon. As the Examiner states, directory revenues could be imputed to the successor that acquires Verizon's assets at a lower price than would otherwise have been the case. We believe that the Commission need not decide whether imputation will continue in any future rate case, but it should make clear in any order approving the Transaction that the issue will continue to be decided on policy, rather than legal, considerations, unless some intervening event specifically precludes the Commission from making such imputation.

OPA No. 21: FairPoint shall propose a cost allocation manual, to be approved by the Commission, to ensure that there is no subsidy from its regulated operations to any of its unregulated businesses, including its broadband business and any video business. FairPoint shall pay the regulated entity the fair share of any joint and common costs attributable to regulated facilities, including the loop.

OPA No. 22: FairPoint shall provide a detailed budget pro forma of charges to and from affiliates for the three-state operation (and the individual states), for 2008, including the actual cost basis for the charge at its originating location.

OPA No. 23: Any management fee or other allocations between the FairPoint parent company, any subsidiary, and the local exchange company, shall be subject to review and approval by the Commission.

a. Positions of the Parties

i. OPA

These conditions are largely self explanatory and are one element of the close financial monitoring the OPA believes is necessary if the Commission decides to approve the Transaction. These proposed conditions are intended to ensure that common costs supporting the NNE states are properly allocated between the various states and the various regulated and unregulated business units of the parent company.

ii. FairPoint

FairPoint generally agrees with all three of these proposed conditions. FairPoint proposes to initially adopt Verizon's CAM and requests approval to file for the Commission's approval under Section 707 all proposed agreements between FairPoint's Maine telephone utility and its affiliates for the provision of services within six months of closing. FairPoint states: "[T]he proposed CAM shall include all policies, procedures, and agreements governing services provided between and among FairPoint affiliates. Such cost allocation manual shall assure that cost of developing the FairPoint systems used to replace the Verizon systems by Cutover are appropriately allocated…" FP Br. at Appendix E-4

b. Recommendation

Under Parts 32, 36 and 64 of the FCC's rules, with which this Commission concurs, FairPoint must file a CAM that describes how the company will allocate its revenues and costs between affiliates and its regulated and non-regulated operations. The CAM rules contain strict allocation principles that each telephone utility must follow. The general philosophy is to prevent any cross-subsidy between the regulated utility and its unregulated affiliates and between regulated and non-regulated services. FairPoint appears to be seeking a 6-month waiver from the date of closing for the filing of its CAM for Commission approval. In the interim, FairPoint asks that it be allowed to adopt the current Verizon CAM. We recommend that the Commission grant the request, on the condition that FairPoint must file with the Commission within one month of closing a report that provides a detailed description of how the Verizon CAM, which obviously applies to Verizon's specific organization and affiliates, will be used specifically by FairPoint in allocating costs. FairPoint has indicated it may seek to adopt the Verizon CAM as its permanent CAM. If FairPoint wants to make that proposal, it also must modify the manual to reflect the specifics of FairPoint's organizational structure.

FairPoint also is seeking a 6-month waiver of the requirement that it file and receive approval of all contracts or arrangements with its affiliated interests, as required by 35-A M.R.S.A. § 707, provided that it complies with the Verizon CAM in the interim. We recommend the Commission grant FairPoint's request, with one clarification that may be simple semantics. In its Brief (FP Br. at E-4), FairPoint uses the phrase "provision of services" to describe the type of agreements that it will file for Commission approval within six months. While it is possible that services will be the dominant (and perhaps only) category of contracts or arrangements that are subject to 35-A M.R.S.A. § 707 approval requirements, we remind FairPoint that *all* contracts or arrangements between FairPoint and any of its affiliated interests require Commission approval, not just those that deal with services.

We are also aware that FairPoint's legacy telephone utilities in Maine use a Master Services Agreement in providing services among the various utilities and other corporate entities. If FairPoint wishes to use such an agreement for its newly acquired service territory in Maine, it must obtain Commission approval, and any such agreement must be submitted for approval within six months of the closing.

We also recommend that, as part of FairPoint's annual report to the PUC, it must include a spreadsheet, chart or other form that shows all revenues and charges to or from its regulated ILEC operations in Maine to any affiliated interest. In this way, the Commission will be able to see the results of all of FairPoint Maine's transactions with its affiliates. Also, FairPoint must describe the basis for the revenues or costs being charged to or from its affiliates, and the Commission may require detailed backup for any of the accounting entries, if the Commission believes it needs that information to carry out its regulatory obligations. We believe the recommended conditions described above resolve all of the issues contained in OPA Conditions 21, 22 and 23.

OPA No. 24: For one year following cutover, and for every year thereafter during which unadjusted net Debt/EBITDA ratio exceeds 4.5 times, FairPoint will not consummate any business acquisition with a transaction value of the acquired business in excess of $100 million without Commission approval.

Neither the OPA nor any other party raised this as a potential issue during the case or in their briefs. We assume that this condition is meant to address the possibility that FairPoint might wish to continue on an acquisition path that would involve incurring more debt before this Transaction is fully "digested." In addition to the possibility of adding more debt, the possibility of distracting management focus would also be of concern, especially with FairPoint's corporate headquarters over 900 miles away in Charlotte, North Carolina. We believe that the Commission has adequate protection in 35-A M.R.S.A § 708 regarding the oversight of reorganizations, because any proposed reorganization would require Commission approval. Therefore, while we do not believe there is a need for the Commission to adopt this as a formal condition of the Transaction, the Commission should put FairPoint on notice that the Commission will retain all authority over the approval of reorganizations granted to it under 35-A M.R.S.A § 708.

2. Labor's Proposed Conditions

In its Brief, Labor stated, "[E]ven if all of FairPoint's assumptions were accepted, those (financial) projections show that FairPoint would not be financially fit if this transaction is approved. Labor Br. at 7. Despite also stating that the imposition of conditions could not, in Labor's opinion, make FairPoint "financially viable," Labor's financial witness Mr. Barber proposed seven financial conditions that the Commission should impose if it decided to approve the Transaction. Labor Br. at 3. These financial conditions, which are modeled on the conditions FairPoint agreed to in Illinois and New York are summarized in Labor's Brief on pages 45 to 47.

Generally, Labor's proposed conditions are of the "ring-fencing" variety that commissions often use to insulate utility operations from parent companies or affiliates that may be more risky than the utility segments of the business. Labor Br. at 46-47. Specifically for Maine and the NNE states, these conditions also are meant to address concerns Labor has with the overall financial health of the "new" FairPoint if the Transaction is approved. Labor believes that FairPoint will not have the cash available for the appropriate level of capital expenditures and to maintain a work force of the appropriate size. Labor Br. at 15. As such, the proposed conditions are primarily intended to prevent cash from leaving the Maine and NNE subsidiaries for the benefit of the parent, FairPoint, Inc.

Labor also noted "FairPoint's reluctance to be bound by any serious financial conditions" and questioned why it would object to proposals that were similar to provisions it has previously agreed to in New York and Illinois. Labor Br. at 43-44. A summary of FairPoint's responses and/or objections to these proposals is provided in its Brief in Appendix E on pages E-5 to E-7, and we will discuss each of them below. Verizon's Brief does not address any of these proposed financial conditions.

Labor No. 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).

FairPoint does not agree with this specific proposal, but offered the following more general proposal instead:

> FairPoint would agree that total dividend payments from FairPoint to its corporate shareholders following the two-year anniversary of the closing will be reduced the following year by the amount the annual average capital expenditures made in Maine over the two years is less than $48 million; dividends paid in the year following the three-year anniversary of the closing will be reduced by the amount the annual average capital expenditures over the three year period is less than $47 million.

FP Br. at 20 FairPoint also noted that "Labor's proposal unreasonably restricts FairPoint's ability to make payments to lenders and investors." FP Br. at Appendix E-5.

Recommendation

In principle, limiting the dividend paid by the Maine or NNE affiliates to the parent (FairPoint, Inc.), if it fails to provide an acceptable level of service to its customers, is sound and reasonable. However, if the Commission approves the proposed Transaction, it will approve a structure where all the debt supporting the acquired operations will be at the parent company level while the vast majority of the cash flow required to service that debt is earned at the operating company level. Therefore, it would be impractical for the Commission to approve the Transaction with the proposed financing arrangement and then prohibit the cash flow from being applied to service the debt that supports the deal. We believe if this condition were approved and was actually triggered at some point, that a default on one or both of the proposed debt instruments would likely ensue shortly thereafter. The uncertainty following such a default would constitute the type of "financial distress" that the parties have contemplated and been striving to avoid throughout this proceeding.

We do not believe our recommendation above should be seen as a recommendation that the Commission ignore service quality issues and all possible remedies. In Section VII of this Report, service quality metrics for FairPoint along with penalties for failing to meet them are discussed in detail and we will not repeat them here. In addition, we recommend that if the Commission approves this Transaction, that it not cede any of the authorities granted to it under 35-A M.R.S.A. § 707 (affiliate transactions) and § 708(2)(A)(8).

Further, we recommend that if the Commission approves this Transaction, that it accept FairPoint's proposal to limit dividends from the Maine affiliate to FairPoint, Inc. (the parent) if it does not reach the capital investment targets noted on page 20 of its Brief. Those targets for Maine were $96 million in the first two years after closing (an average of $48 million per year) and $141 million in the first three years after closing (an average of $47 million per year).

Labor No. 2: <u>Dividends on common stock of FairPoint's existing operations in Maine must be suspended if service quality at FairPoint's existing operations in Maine deteriorates, using the same criteria to be established for NNE (as discussed by Dr. Peres).</u>

FairPoint opposes the imposition of this condition and offers the same dividend commitment as it does in response to Labor No. 1.

Recommendation

We assume that the dividends Labor proposes to restrict with this condition are the inter-company dividends paid from FairPoint's existing Maine properties (the Utilities, Inc. companies, Northland, Sidney, Cobboseecontee, Community Service, etc.) to the parent, FairPoint, Inc. Our analysis and recommendation regarding Labor No. 2 is the same as it was for Labor No. 1, that is, we would not recommend that the Commission adopt this condition if it approves the Transaction, and would recommend the Commission accept FairPoint's proposal and apply it to the existing FairPoint companies. Given the relative size of the existing FairPoint Maine companies, we would not expect that restricting upstream dividends from these companies would, by itself, trigger a default on the parent company's acquisition debt instruments as would likely be the case if we restricted dividends from the NNE companies. However, since existing FairPoint debt is to be refinanced as part of this Transaction, the general principle that cash flow should be available to service debt supporting the existing companies is the same.

Labor No. 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.

Labor No. 4: NNE will not provide any financial guarantees to facilitate this, or any other acquisition.

These conditions are designed to insulate the NNE operating companies from financial difficulties or distress at the parent company level and FairPoint has agreed to both.

Recommendation

The deal, as structured, carries all the acquisition debt at the parent company level and it is not secured by NNE utility assets and is not backed by a financial guaranty from the NNE properties. Essentially, the parties have therefore agreed on these provisions. While FairPoint has already acknowledged it in its Brief at Appendix E-5, we remind the other parties that 35-A M.R.S.A §§ 707(3) and 1101 respectively require utilities to obtain Commission approval to issue a financial guarantee in favor of an affiliate or to mortgage or otherwise assign utility property. We therefore do not believe that it is necessary for the Commission to impose either of these as formal conditions if the Transaction is approved. We do recommend that the Commission make clear that it would not waive any of the powers or authorities granted it under these statutes by approving the Transaction.

Labor No. 5: The amount of annual dividends NNE can distribute to FairPoint Parent is further limited as follows:

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.

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.

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.
>
> 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.

FairPoint believes that similar to Labor No. 1, this proposal unreasonably restricts FairPoint's ability to make payments to lenders and investors and does not agree to it. FP Br. at Appendix E-5. In response to this proposal, FairPoint offered the same dividend limitation condition as it did in response to Labor Nos. 1 and 2.

Recommendation

For the reasons we noted above in our discussion of Labor No. 1, we do not recommend that the Commission adopt this condition. In addition, in his Rebuttal Testimony, Mr. Leach stated: "Depreciation is a function of capital spent in prior years when the number of access lines was higher and equipment costs were more expensive, while capital expenditures today are representative of the current needs of the business, and should logically be lower." Leach Reb. at 53. We agree with this premise and do not see the need to link the level of capital expenditures and inter-company dividends.

Our recommendation should not be taken as a signal that the Commission should not carefully monitor normal capital expenditures, the promised broadband investments and performance pursuant to any service quality metrics the Commission may chose to impose.

Labor No. 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%.

This condition is self explanatory and is apparently meant to provide another safeguard against cash being drained from the NNE affiliates by the parent. FairPoint does not agree and its witnesses have consistently maintained throughout this case that the book value common equity ratio is not a cause for concern in the investment community and should not be a concern for the Commission. FP Br. at 37-38. Mr. Kahal, the OPA's principal witness on capital market issues generally concurred with this opinion stating that it was not a cause for concern "by itself." Tr. 10/05/07 at 168.

Recommendation

We believe Labor No. 6 is an attempt to move the new FairPoint toward an investment grade credit rating and to ensure that an appropriate level of capital spending occurs in the NNE region. Earlier in our discussion of the OPA Nos. 1 and 2, we stated that we could not recommend the Commission's approval of the Transaction without both a substantial $600 million reduction in the amount of debt incurred at the outset of the transaction as well as a substantial dividend decrease of approximately 30% (or $42 million annually). We believe that these fundamental changes in the structure of the Transaction, if adopted by the Commission, would address the concern that Labor attempts to address. We therefore do not recommend that the Commission include this condition if it chooses to approve this Transaction.

Interestingly, this proposal brings up a potential issue in any future FairPoint rate case. Mr. Leach stated in his Rebuttal Testimony: "it is likely the parties will agree on the need for an imputed capital structure for the Maine operations…" Leach Dir. at 34. This begs the question: If the company chooses as a matter of corporate policy to "dividend-away" the book value of its operating companies to the point where it has an actual capital structure comprised of 100% debt, is the Commission under any obligation to impute equity into the ratemaking calculation?

Although this does not need to be resolved at this time, the issue is whether imputing equity, after FairPoint made a conscious decision to pay dividends at a rate that resulted in negative book value on its balance sheet, would be akin to paying an acquisition premium, essentially requiring ratepayers to pay twice for the same investment. In his Direct Testimony, Mr. Leach stated that FairPoint will not at any time in the future request the recovery of an acquisition premium or transaction costs resulting from this transaction from retail ratepayers. Leach Dir. at 34. If the Commission chooses to approve this Transaction, we recommend that it include a condition that prohibits FairPoint from recovering an acquisition premium or transaction costs from Maine ratepayers and that the Commission is under no obligation to impute common equity to the company's capital structure in a future ratemaking calculation. The Commission should simply state that the appropriate capital structure for rate making purposes will be determined in any future rate case involving FairPoint's Maine operations.

Labor No. 7: NNE and its subsidiaries shall be prohibited from making any loans or financial advances to FairPoint.

This condition is intended to provide another safeguard against cash being drained from the NNE affiliates by the parent. FairPoint does not agree and, again, states that such a condition would unreasonably limit its ability to make payments to its lenders and investors. FP Br. at Appendix E-6.

Recommendation

FairPoint's reaction to this proposal is somewhat perplexing. Title 35-A M.R.S.A. §707(3) clearly states: "No public utility may extend or receive credit, including the guarantee of debt, or make or receive a loan to or from an affiliated interest…" without prior approval from the Commission. Therefore, we will not recommend that the Commission impose this as a formal condition, but it should simply remind FairPoint that its NNE/Maine subsidiary will be bound by statute not to make loans or advances to any affiliate without prior Commission approval.

3. Conclusion

For the reasons discussed above, recommend, if the Commission chooses to approve this Transaction, that the Commission consider the following conditions:

V-D-1	Require the transaction to be restructured to reduce FairPoint's bond debt by $600 million.
V-D-2	Require FairPoint to immediately reduce the dividends it pays to its shareholders by $42 million.
V-D-3	Require FairPoint to file the "near final" loan agreements for Commission review and approval prior to closing with the Commission reserving the right to impose additional mitigating conditions if the terms materially change.
V-D-4	Require FairPoint to provide detailed quarterly and annual financial results as well as copies of all financial filings made with the FCC and SEC.

V-D-5	Establish a specific annual report form for FairPoint.
V-D-6	Allow FairPoint to temporarily adopt Verizon's CAM conditioned on FairPoint filing with the Commission within one month of closing a report that provides a detailed description of how the Verizon CAM will be used specifically by FairPoint in allocating costs.
V-D-7	Require FairPoint, as part of its annual report, to include a spreadsheet, chart or other form that shows all revenues and charges to or from its regulated ILEC operations in Maine to any affiliated interest.
V-D-8	Prohibits FairPoint from recovering an acquisition premium or transaction costs from Maine ratepayers and make clear the appropriate capital structure for rate making purposes will be determined in any future rate case involving FairPoint's Maine operations.

VI. WHOLESALE ISSUES, BACK OFFICE SYSTEMS AND BROADBAND

A. Wholesale Issues

1. FairPoint Lack of Experience on Wholesale Issues

a. Background

Since 1996, Verizon has been subject to the local market-opening provisions of the TelAct. Over the past eleven years, Verizon and the CLEC community have worked to develop a system to handle the wholesale requirements of sections 251, 252, and 271 of the TelAct, among others. It has been a long, sometimes painful road, with both sides learning how to interact in the new environment. Over the years there have been numerous changes in the rules and regulations governing the relationship between ILECs and CLECs leading to years of litigation and an ever-changing environment.

FairPoint, as a rural carrier, has not been subject to the requirements of sections 251(c), 252, and 271. Thus, until now, it has not had the need to develop the expertise or operating systems needed to handle large-scale wholesale operations.

b. Positions of the Parties

i. One

According to One, none of the 64,000 access lines FairPoint owns in Maine, New Hampshire, and Vermont is sold to a wholesale purchaser. One Br. at 6; Ex. One-2. Further, FairPoint has conceded in filings with the SEC that it has no wholesale experience in the other states in which it operates as an ILEC and that it may have difficulty hiring workers qualified to carry out wholesale operations. One Br. at 7; Ex. One-3. One points to the many commitments FairPoint has made in the course of the proceeding (broadband expansion, continued dividends, hiring 675 additional employees, improving service quality) and argues that it is "hard to imagine how the Merged Firm will be able to follow through on all of these promises simultaneously, let alone make good on any obligations to competitors." One Br. at 13. One argues that given these competing commitments, "it is reasonable to conclude that CLECs will be the first to suffer degraded service from FairPoint when finances and other resources become limited" because it would benefit FairPoint to degrade wholesale service to CLECs and enhance its own position as a retail service provider. One Br. at 13.

ii. FairPoint

FairPoint claims that wholesale customers in Maine will benefit from FairPoint's "substantial efforts to develop state-of-the-art wholesale systems and provide first-class service." FP Br. at 88. FairPoint claims that it "has every incentive" to provide these benefits because the wholesale segment of its new business will be the second-largest revenue stream in the three-state area and "is absolutely critical to the success of the company." *Id.* Thus, FairPoint claims it is "determined to expand the wholesale side of the business" by providing "high-quality service, competitive prices and diverse product offerings." *Id*.

FairPoint further argues that its new back office systems will benefit CLECs and that it will seek to enhance wholesale service by responding to "productive" suggestions made by the CLEC community. *Id*. at 90. FairPoint claims that the inclusion of wholesale customer suggestions "will help to provide a healthy wholesale business, and in return, will foster competition in Maine." *Id.*

FairPoint also claims that it is in the process of assembling an "experienced and fully staffed division of nearly 100 people" to meet wholesale customers' needs. *Id.* at 91. FairPoint states that the persons hired to lead and manage the wholesale operations are "telecommunications industry veterans, and managers who have significant experience that will benefit wholesale customers." *Id*. FairPoint points out that many current Verizon employees will transfer into the FairPoint wholesale organization and that most of the wholesale division personnel, with the exception of the account teams, will be located in the three-state area. *Id*. FairPoint states that its wholesale division "aims to have an excellent working relationship with wholesale customers" and, to that end, "will provide concrete escalation procedures to resolve any disputes or problems in a timely and professional manner." *Id*. at 92.

c. Recommendation

Overall, the Examiners are concerned with FairPoint's ability to cover its new wholesale responsibilities, especially given that FairPoint will be using new back office systems that both it and the CLECs will need to learn how to use. It took Verizon and the CLECs many long years, with hundreds, if not thousands, of battles regarding wholesale operations and obligations, to reach a place where each finally understands how to make the system work. While we appreciate, and believe, FairPoint's willingness to work with the CLECs rather than against them, experience tells us that may be more easily said than done. The Commission has worked diligently for eleven years to open the local market in Maine to competition. While the number of CLECs operating in the state may be small, several of them have made substantial inroads and we do not wish to see that progress reversed by an inadequately prepared FairPoint wholesale operation.

Rather than reach a specific recommendation regarding FairPoint's wholesale operations in general, we believe it more helpful to work through the issues raised by the parties and make recommendations to the Commission regarding how it could best avoid any significant negative impact on wholesale operations if it chooses to approve the Transaction.

2. FairPoint's status as an RBOC

a. Background

Section 271 of the TelAct applies to Regional Bell Operational Companies (RBOCs or BOCs), defined under section 153 as a certain list of operating companies, including New England Telephone and Telegraph Company (NYNEX), *and* "any successor or assign of any such company that provides wireline telephone exchange service." 47 U.S.C. § 153(3). Section 271 allows RBOCs to enter into the interLATA exchange market if they meet certain market-opening requirements contained in a 14-point competitive checklist. 47 U.S.C. § 271. In 2000, NYNEX changed its name to Verizon New England Inc.

In this proceeding, an issue has arisen regarding whether FairPoint, which would be acquiring only a portion of Verizon New England, Inc., will be an RBOC and bound by the requirements of section 271 and other provisions of the TelAct applicable to RBOCs (47 U.S.C. §§ 252 (interconnection agreements), 272 (separate affiliate requirements), 273 (manufacturing by BOCs), 274 (electronic publishing by BOCs), 275 (alarm monitoring), and 276 (provision of payphone service)).[42]

b. Positions of the Parties

i. CLECs

Both One and the CLEC Coalition contend that the question of whether FairPoint is an RBOC is critical to any decision by the Commission that this Transaction is in the public interest. GWI contends that "if the Commission approves the proposed transaction, CLECs will be significantly harmed in their abilities to purchase telecommunications services in Maine at reasonable rates" and that "all ratepayers will be harmed indirectly by the detrimental effect on the competitive landscape." GWI Br. at 11. One and the CLEC Coalition argue that the plain language of the TelAct requires that FairPoint be treated as a BOC if the Transaction is approved. CC Br. at 10; One Br. at 16. They argue that the three ILECs being acquired are unquestionably part of the old NYNEX, specifically named in the TelAct's definition of an RBOC. CC Br. at 10; One Br. at 16 *citing* 47 U.S.C. § 153(4)(A).

The CLEC Coalition argues that the requirements of section 271 will become even more important over time as the FCC makes additional findings of non-impairment or forbears from section 251 obligations as competition further develops. CC Br. at 11.

[42] Sections 252, 271 and 272 appear to be the provisions of most interest to the parties to this proceeding.

One contends that under the relevant common law test applied by the Supreme Court in *Fall River Dyeing v. NLRB*, FairPoint is a "successor or assign" of Verizon if there is "substantial continuity" between Fair Point and Verizon in the relevant geographic and product markets. One Br. at 16 *citing Fall River Dyeing v. NLRB,* 482 U.S. 27 (1987). One argues that continuity exists between FairPoint and Verizon and that, therefore, FairPoint should be subject to the requirements applicable to BOCs. One Br. at 16.

The CLECs acknowledge FairPoint's voluntary commitments regarding the provision of section 271 checklist items, but argue that such voluntary, non-binding commitments are not sufficient to ensure the continued opening of the local markets to competition. One Br. at 16. GWI also contends that it is very unclear exactly what FairPoint is committing to offer CLECs. GWI Br. at 9. One argues that Congress placed special obligations on BOCs (sections 271 and 272) on a state-by-state basis "because even the extensive legal requirements applicable to incumbent LECs under Section 251(c) were insufficient to ensure BOCs' continued cooperation in the provision of inputs to CLECs." One Br. at 17. One further argues that statements made by FairPoint witness Lippold reflect FairPoint's belief that without its voluntary commitments, Maine CLECs would not be entitled to section 271 checklist items. One Br. at 16 citing Tr. 10/10/07 at 98. Thus, according to One, accepting FairPoint's non-binding commitment "would leave the door open for the Merged Firm to change its mind about providing wholesale inputs to competitors and effectively gut the BOC-specific requirements of the Act." One Br. at 16.

ii. FairPoint

FairPoint claims that the Commission may not have the jurisdiction to consider the "novel question of federal statutory interpretation" of whether FairPoint qualifies as an RBOC. Skrivan Reb. at 26. FairPoint argues that the FCC clearly has such authority and that the question has been fully briefed before the FCC. Skrivan Reb. at 26. FairPoint further argues that the only reason certain parties want FairPoint to be considered an RBOC is to invoke the 271 competitive checklist. Skrivan Reb. at 26. FairPoint contends that its voluntary commitment to "provide access in the acquired territory to all 'competitive checklist' items required of the Bell Operating Companies ("BOCs") pursuant to section 271(c)(2)(B) of the Act, to the extent the FCC has ruled that BOCs in general are required to provide such items" is sufficient to meet both the CLECs' interests and the public interest. FP Br. at 81. FairPoint states that the rates, terms, and conditions for the 271 checklist items would be determined with the standards set by the FCC. FP Br. at 81. FairPoint commits that as BOCs' obligations change over time, FairPoint's obligations would also change. FP Br. at 81. FairPoint argues that the Commission should follow the First Circuit's recent ruling that "states have no independent authority to require BOCs to tariff network elements pursuant to section 271 that the FCC has delisted under section 251, such as line sharing and certain dark fiber facilities." FP Br. at 81.

FairPoint argues that no other company has ever been named an RBOC because it purchased "BOC exchanges." Skrivan Reb. at 27. FairPoint points to a number of purchases made over the years and argues that because none of these were considered to be successors or assigns, FairPoint should not be considered a successor or assign of Verizon. Skrivan Reb. at 28-29. Finally, FairPoint contends that if the Commission were to pursue interpretation of whether it qualifies as an RBOC, "it would open up a veritable Pandora's Box of complex legal questions, including questions concerning jurisdiction to interpret Section 3 of the Communications Act, as well as those regarding how other aspects of the BOC regulatory framework should apply to FairPoint under federal law." FP Br. at 82. According to FairPoint, it should be the FCC, not the Commission, which makes this legal determination. FP Br. at 82.

c. Legal Precedent

First, as pointed out by One, the Supreme Court has found that in determining whether one company is the successor of another, the focus should be on whether there is "substantial continuity" between the enterprises. *Fall River Dyeing & Finishing Corp. v. NLRB,* 482 U.S. 27, 43 (1987). The Supreme Court stated that a number of factors must be considered: "whether the business of both employers is essentially the same; whether the employees of the new company are doing the same jobs in the same working conditions under the same supervisors; and whether the new entity has the same production process, produces the same products, and basically has the same body of customers." *Fall River* at 43. Further, successorship is "based upon the totality of the circumstances of a given situation, requires that the Board focus on whether the new company has "acquired substantial assets of its predecessor and continued, without interruption or substantial change, the predecessor's business operations"). *Id.*

The FCC relied upon *Fall River* in its decision approving the merger of SBC and Ameritech. *In re Applications of Ameritech Corp., Transferor, and SBC Communications Inc., Transferee, For Consent to Transfer Control et al.*, Memorandum

Opinion and Order, 14 FCC Rcd 14712 (1999) (*SBC/Ameritech Order*). The Order imposed various conditions on the merger and specifically addressed whether an advanced services affiliate of the merged entity would be a successor or assign. In addressing this issue, the FCC set forth its interpretation of "successor and assign." The FCC stated that the term should be interpreted in a manner that promotes pro-competitive purposes of 251, which are to open the local exchange market to competition in all services. *Id.* at ¶ 452. The FCC cited to the *Falls River* decision in finding that the determination of whether a particular transaction results in a "successor or assign" is fact-based and requires "substantial continuity" such that one entity steps into the shoes of or replaces another. *Id.* at ¶ 454. The FCC found that substantial continuity depended on whether the company "had acquired substantial assets of its predecessor and continued, without interruption or substantial change, the predecessor's business operations."[43] *SBC/Ameritech Order* at ¶ 454.

[43] In applying its interpretation, the FCC found a rebuttable presumption that the affiliate was not a successor or assign. *SBC/Ameritech Order* at ¶ 454. Whether the affiliate would in the future be classified as a successor or assign would depend on its behavior in the marketplace and its relationship to the parent company. *SBC/Ameritech Order* at ¶ 454. Because the parent company was only transferring the assets necessary to provide advanced services and not the assets necessary to continue the incumbent's traditional POTS (Plain Old Telephone Service) business operations, the FCC found the affiliate was not an RBOC, thereby allowing it to avoid the requirements of section 251(c). *SBC/Ameritech Order* at ¶ 463. The FCC's decision was overturned in *Assoc. of Communication Enterprises v. FCC,* 235 F.3d 662 (D.C. Cir. 2001), which specifically challenged that part of the *Ameritech/SBC Order* that allowed the advanced affiliate to avoid 251(c). While it is not clear whether the Court specifically overruled the FCC's interpretation of "successor or assign," it did find that its application in the *Ameritech/SBC* case was a circumvention of the statutory scheme. 235 F.3d at 666. The Court disagreed with the FCC's determination that the affiliate was not a successor or assign because the parent did not transfer its traditional business operations – its monopoly assets. *Id*. The Court found that TelAct was intended to "check LECs' incentive to leverage their bottle-neck assets…" 235 F.3d at 667.

d. Recommendation

First, we believe that the Commission can and should decide the question of whether FairPoint will be an BOC if the Transaction is approved. Such action by the Commission is no different than previous proceedings where the Commission interpreted and applied provisions of the TelAct and FCC orders. *See Mid-Maine Telplus, Re: Request for Arbitration of an Interconnection Agreement with Bell Atlantic*, Order Addressing Subloop and Extended Link Issues (E3 and E7) – Part 2, Docket No. 98-593 (April 9, 1999) (*Mid-Maine*); *Investigation Into Total Long Run Incremental Cost (TELRIC) Cost Studies and Pricing for Unbundled Network Elements,* Docket No. 1997-505, Order (Feb. 12, 2002); *Investigation into the Routine Network Modification Requirements of the Federal Communication Commission's Triennial Review Order and the Rapid Response Complaints of Skowhegan Online, Inc. (4/21/04) and Cornerstone Communications Inc.'s (5/6/04),* Order (Oct. 21, 2004).

Based upon the Examiners' review of the legal precedent and the facts presented in this proceeding, we recommend that the Commission find that FairPoint is a successor and assign of Verizon and therefore subject to the requirements of section 271 as well as all other obligations applicable to BOCs under the TelAct. First, similar to the Court in *Fall River,* we find substantial continuity between Verizon and FairPoint if the Transaction is approved – FairPoint is acquiring most of the assets necessary to continue Verizon's traditional operations, including physical assets and employees. Operations will continue uninterrupted – the transition from Verizon to FairPoint should be invisible to customers. Further, the business of both Verizon and FairPoint will be essentially the same -- former Verizon employees will perform the same jobs under essentially the same working conditions as when Verizon owned the company and FairPoint will offer the same types of products to the same body of customers. *See Fall River*, 482 U.S. at 43; *SBC/Ameritech Order* at ¶ 454. Finally, such a decision supports the pro-competitive purposes of the TelAct and is consistent with the FCC's interpretation of "successor and assign."[44]

2. Interconnection Agreement Issues

a. Legal Requirements

A review of GWI's interconnection agreement, which this Commission has previously found to be similar to many other CLECs' interconnection agreements, indicates that it contains a provision stating that: "[T]his Agreement shall be binding on and inure to the benefit of the Parties and their respective legal successors and permitted assigns." *See* Attachment B to GWI Br. at § 39.

b. Positions of the Parties

i. CLECs

The CLEC Coalition states that while FairPoint has made commitments relating to section 251, "there remain questions regarding the scope of this commitment that need to be nailed down in the form of conditions." CC Br. at 4. One contends that the Commission "must preclude the Merged Firm from exploiting any opportunities created by the proposed transaction to raise CLECs' costs under existing interconnection agreements" and thus FairPoint should be required to extend any intercarrier

[44] Thus, the Commission would not be interpreting the term "successor and assign" in the first instance but instead applying the FCC's interpretation to the particular facts before it. Accordingly, FairPoint's arguments concerning the Commission's lack of jurisdiction to interpret the term "successor and assign" are without merit.

agreements for three years, as FairPoint already agreed to do in New Hampshire. One Br. at 27-28.

ii. FairPoint

In Maine, FairPoint has committed to adopt the existing interconnection agreements between Verizon and individual CLECs and keep the existing terms in place for one year. FP Br. at 78-79; Tr. 10/10/07 at 8. Regarding any interconnection agreements on a month-to-month status or any that might be due to expire, FairPoint committed to keeping the same one year status quo regarding terms and conditions. *Id.* In New Hampshire, FairPoint has signed a settlement agreement with four CLECs that would extend the existing interconnection agreements for three years. *See* Settlement Stipulation Among FairPoint Communications, Inc. and Freedom Ring Communications LLC, d/b/a BayRing Communications, LLC, segTel Inc., and Otel Telekom, Inc. (NH CLEC Settlement) filed as an attachment to the Motion to Reopen Record filed by the CLECs (One, GWI, and the CLEC Coalition) in this proceeding on October 24, 2007.[45] In its response to the Hearing Examiner's request that FairPoint delineate which provisions of the CLEC Settlement would apply to Maine CLECs, FairPoint did not list the three year extension on interconnection agreements. *See* FairPoint's Second Comment on NH Settlement Agreement dated October 20, 2007, at Appendix A.

c. Recommendation

Given our recommendation above, we believe that regardless of any voluntary commitments, FairPoint would be considered a successor or permitted assign under Verizon's interconnection agreements and would be bound to honor their terms.

[45] We recommend the Commission grant One's request that we take official notice of this document filed with the New Hampshire PUC.

FairPoint appears to recognize this and has volunteered to extend the terms of any agreement (even month-to-month) for one year following closing. We believe, however, that such a time commitment is too short, given all that will occur during the first year, if the Commission approves the Transaction. While FairPoint plans to cutover to its new back office systems by May 2008, it is likely (see discussion below) that the cutover will be delayed until at least July 2008. All parties – FairPoint and the CLECs - will be working to adjust their operational systems to the new back office systems. We believe that it is too much to expect of both FairPoint and the CLECs to be engaging in interconnection agreement negotiations while the transition takes place. Indeed, if things do not go as smoothly as FairPoint plans, all parties, including the Commission, will be busy trying to rectify the situation and keep their operations going. Further, it is possible that the negotiations, mediation and arbitration processes will be needed to address issues that arise during or immediately following cutover. As such, some "cooling off" period between cutover and the need to negotiate new interconnection agreements appears to make sense.

Accordingly, we recommend that the Commission consider imposing a condition requiring FairPoint, if requested by an interconnecting carrier, to extend all the terms of its existing interconnection agreements by at least two years. Given that FairPoint has already agreed to three-year extensions with New Hampshire CLECs, the Commission may choose instead to impose a similar condition here in lieu of our two-year proposal.

3. Wholesale Tariff Obligations

a. Background

In Docket No. 2000-849, as a condition to the Commission's support of Verizon's petition to the FCC to enter the interLATA long distance market, Verizon committed to filing a wholesale tariff setting forth both the prices and terms and conditions associated with sections 251 and 252 of the TelAct. As a result of the protracted litigation associated with whether Verizon also agreed to provide a wholesale tariff covering its obligations under section 271 of the TelAct,[46] the Commission has yet to approve the draft wholesale tariff submitted in November 2002.

b. Positions of the Parties

i. CLECs

In its written testimony, which was filed before the First Circuit issued its decision regarding Verizon's 271 wholesale tariff obligations, the CLEC Coalition maintained that FairPoint should be required to file a wholesale tariff covering both its section 251 and 271 obligations. Winchester Dir. at 8-9. GWI argued that any approval of the Transaction should be conditioned on FairPoint making a long-term commitment to providing 271 checklist items. Kittridge Dir. at 13-14. In its brief, the CLEC Coalition continues to argue that, as a condition of this Transaction, FairPoint should be required to file a tariff with all of its section 271 offerings. CC Br. at 9-10. It argues that the best way to ensure that the market-opening requirements of 271 continue to be met and to avoid discriminatory agreements with individual CLECs is to require FairPoint to file a

[46] *See* discussion of *Verizon New England, Inc. v. Maine Public Utilities Commission*, No. 06-2151, 2007 U.S. App. LEXIS 21349 (1st Cir, Sept. 6, 2007) in Section VI(A)(5) *infra.*

wholesale tariff that includes section 271 items. *Id*. Accordingly, we recommend that, if the Commission approves the Transaction, require FairPoint to file an updated version of Verizon's wholesale tariff within a year of closing.

ii. FairPoint

FairPoint maintains that a wholesale tariff is unnecessary and that the public interest would be better served if FairPoint reached individual agreements with individual carriers. Tr. 10/10/07 at 276. However, FairPoint conceded during hearings that if the Commission insisted on a wholesale tariff for section 251 elements, it would comply with the requirement. Tr. 10/10/07 at 80. During the hearings, FairPoint maintained that it had no obligation, nor any intention to, file a wholesale tariff covering section 271 obligations. Tr. 10/10/07 at 86.

c. Recommendation

Given the parameters of the First Circuit's decision regarding the Commission's lack of authority to require Verizon to file a wholesale tariff covering its section 271 obligations, it is clear that FairPoint should not be subject to such a requirement. *Verizon New England, Inc. v. Maine Public Utilities Commission*, No. 06-2151, 2007 U.S. App. LEXIS 21349 (1st Cir, Sept. 6, 2007) *(Wholesale Tariff Appeal)* at 19. With regard to section 251, however, the reasons for requiring a wholesale tariff remain as relevant today as they were in 2002. Specifically, having a wholesale tariff available to CLECs (in addition to requiring that each CLEC have a separate interconnection agreement with the ILEC) allows CLECs to quickly take advantage of any changes in terms and conditions rather than having to wait for the completion of the often long interconnection agreement negotiation process.[47] Accordingly, we recommend that, if the Commission approves the Transaction, require FairPoint to file an updated version of Verizon's wholesale tariff within a year of closing.

4. Section 251 obligations and UNE Rates

a. Background

Under section 251(c) of the TelAct, ILECs are subject to requirements relating to interconnection and access to unbundled network elements (UNEs). Through cross reference to section 252, these two sections taken together set up the legal framework governing both relationships between ILECs and CLECs and the pricing and availability of interconnection, UNEs, resale and other services. Currently, Verizon charges CLECs Commission-set TELRIC[48] rates for section 251 UNEs. *See* Docket No. 97-505. Section 251(f)(1) provides rural ILECs with an exemption from the requirements of section 251(c) until a state commission finds that the protection of the exemption is no longer required. Section 251(f)(2) allows any carrier with less than 2% of the nation's subscriber lines to petition a state commission for suspension or modification of the requirements of section 251(b) and/or (c). FairPoint, if the Transaction is approved, would own less than 2% of the nation's lines and thus would qualify to invoke section 251(f)(2) if the Transaction is approved.

[47] We note that our comments regarding the lengthy negotiation periods pertain to our experience with Verizon. While FairPoint has no track record and may prove to be much quicker than Verizon, it is also quite possible that it may take FairPoint some time to "get up to speed" in this area.

[48] TELRIC stands for Total Element Long-Run Incremental Cost.

b. Positions of the Parties

i. CLECs

The CLEC Coalition argues that, "[g]iven the unrealistic revenue projections forecasted by FairPoint, it is likely that FairPoint will also be forced into seeking to obtain revenue relief in rates charged to CLECs." CC Br. at 21. It also argues that FairPoint will "face strong pressure to seek rate relief to recover the costs of its new OSS… that CLECs have already paid for, to the extent included in UNE rates." CC Br. at 21. The CLEC Coalition states that a review of other recent mergers involving ILECs indicates that freezing rates in order to provide wholesale stability to CLECs is an important condition and argues that FairPoint's one-year freeze is not sufficient nor is the three-year commitment in New Hampshire sufficient. CC Br. at 24. Rather, because of FairPoint's lack of experience in provisioning UNEs and confidential arrangements between FairPoint and MCI/Verizon, the CLEC Coalition contends that a five-year rate freeze for section 251 UNEs is appropriate. CC Br. at 24. One argues that to prevent the Transaction from impairing competition, UNE prices should be frozen for at least three years. One Br. at 27.

With regard to section 251(f) issues, both One and the CLEC Coalition argue that FairPoint should not be allowed to assert any right to file for an exemption under section 251(f)(2). One Br. at 21; CC Br. at 8. They argue that allowing FairPoint to file for such an exemption would put CLECs in a worse position than they are today because Verizon would not qualify for an exemption. *Id.*

ii. FairPoint

FairPoint does not contest that it will be subject to the requirements of section 251. Skrivan Reb. at 5. FairPoint states that it will not seek an increase in section 251 UNE rates for one year. FP Br. at 80. In its testimony, FairPoint states that it will not "assert rural exemptions of its section 251 obligations pursuant to section 251(f)(1)." Skrivan Reb. at 5. Initially in this proceeding, FairPoint also took the position, with regard to section 251(f)(2) exemptions, that it was explicitly reserving the right to file such a request with the Commission in the future if it finds itself in a situation where it believes the public interest would be served by such an exemption. Skrivan Reb. at 25. However, in its Brief at footnote 20, FairPoint states that "[w]ith this filing, FairPoint commits not to assert any right it might otherwise have to seek suspension of modification of a section 251(b) or (c) in the acquired properties pursuant to section 251(f)(2)." FP Br. at 79.

c. Recommendation

There appears to be no argument that FairPoint will be subject to the obligations of section 251(c). As for the issue of a section 251 UNE freeze, we find that FairPoint's voluntary commitment of one year is too short. As stated above in our discussion of interconnection agreements, given all that will occur during the first year relating to the cutover to new back office systems, we do not believe a TELRIC pricing proceeding should be the focus of any party's efforts. We also believe, however, that the five-year freeze proposed by the CLEC Coalition is too long. Indeed, none of the cases it cites imposed such a long freeze. Further, current TELRIC prices are based on Verizon cost studies from 1996-1997 – a five-year stay out would mean that prices would be based upon Verizon data from fifteen years ago. Accordingly, we recommend, if the Commission approves this Transaction, that it impose a specific condition requiring FairPoint to abide by section 251 and impose a three-year freeze on section 251 UNE rates.

As for section 251 issues, FairPoint's commitment in its Brief not to seek either a section 251(f)(1) or 251(f)(2) exemption addresses the concerns raised by the CLECs. In order to make such a commitment enforceable, we recommend that if the Commission approves the Transaction, it should include a condition prohibiting FairPoint from seeking either a section 251(f)(1) or 251(f)(2) exemption.

5. Section 271 Obligations

a. Background

Section 271 provides that, upon a showing by an ILEC that it has fulfilled the market-opening requirements of the so-called "competitive checklist" found at §271(c)(2)(B), the ILEC will be permitted to enter the interLATA toll market – a market that had been closed to ILECs by the court-ordered breakup of AT&T. 47 U.S.C. §271(c)(2)(B). Checklist Item No. 2 requires "nondiscriminatory access to network elements in accordance with the requirements of sections 251(c)(3) and 252 (d)(1)." Section 251(c)(3) requires ILECs to provide access to their network, i.e. UNEs, while Section 252(d)(1) sets the pricing standard for those UNEs, i.e., TELRIC pricing. Thus, Checklist Item No. 2 requires an ILEC to meet all of the 251 and 252 unbundling and pricing standards, which the FCC limited to specific types of loops, subloops, and transport in its *Triennial Review Order*.[49]

Checklist Items Nos. 4, 5, 6, and 10 require ILECs to provide unbundled access to loops, transport, switching and signaling. The FCC has explicitly found that, despite elimination of a number of UNEs under section 251, ILECs must continue to provide access to those UNEs under section 271. *TRO* at ¶ 653. However, none of these other checklist items, unlike Checklist Item No. 2, cross reference sections 251(c)(3) and 252(d)(1). Thus, according to the FCC in the *TRO*, UNEs unbundled under Checklist Items Nos. 4, 5, 6 and 9 must only meet the "just and reasonable" standard of 47 U.S.C. §§ 201-202 and not the TELRIC standard required under section 251. *TRO* at ¶ 656.

The First Circuit Court of Appeals recently ruled on litigation between Verizon and the Commission regarding the extent of Verizon's section 271 obligations and the Commission's jurisdiction to interpret and enforce Verizon's section 271 obligations. *Wholesale Tariff Appeal,* 2007 U.S. App. LEXIS 21349. The Court found that Verizon had not promised to file a tariff covering its section 271 obligations, and that the Commission did not have the authority to require Verizon to provide elements under section 271 nor to determine their pricing. *Id.*

[49] *Report and Order and Order on Remand and Further Notice of Rulemaking, Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, CC Docket 96-98 et al., 18 FCC Rcd 16978 (rel. August 21, 2003)(*Triennial Review Order or TRO*).

b. Positions of the Parties

i. CLECs

As stated earlier, a number of the CLECs argued that FairPoint should be required to file a wholesale tariff for section 271 obligations as a condition of any decision by the Commission to approve this Transaction. However, as pointed out above, the First Circuit decision prohibits the Commission from imposing such a condition.[50]

The CLEC Coalition argues that if the Commission does not impose a 271 wholesale tariff requirement, it should require that all agreements relating to section 271 obligations "be filed with the Commission and made available to other CLECs upon similar rates, terms and conditions for access to these important network assets." CC Br. at 10. The CLEC Coalition acknowledges that the rules for public filing of section 251 obligations are well established, and argues that the same principles should apply to section 271 obligations in order to protect smaller CLECs who do not have the same bargaining power as the ILECs. *Id.*

One raises the issue of enforceability of FairPoint's section 271 obligations, especially if the Commission (or the FCC) does not find FairPoint to be an RBOC. One points out that if FairPoint is not an RBOC, then the enforcement provisions of section 271(d) will not apply, leaving it unclear where a party can and/or should file a complaint regarding non-compliance with section 271. One Br. at 17. Thus, One argues that the Commission should impose, as a condition to any approval of this Transaction, the

[50] It is not clear whether, if FairPoint were to voluntarily and explicitly consent to a section 271 tariff, the Commission would be prohibited from enforcing such a requirement.

Section 271 dispute resolution provisions of the NH CLEC Settlement. The NH CLEC Settlement explicitly states that the CLECs could bring disputes related to FairPoint's offering of Section 271 services to the Commission for resolution. One Br. at 18.

GWI argues that its interconnection agreement with Verizon requires Verizon to provide access to section 271 UNEs at TELRIC rates until the agreement is amended. GWI Br. at 5-8. Specifically, GWI argues that even with the First Circuit's ruling, and even if the District Court issues a mandate prohibiting the Commission from requiring TELRIC rates for section 271 UNEs, GWI's interconnection agreement will still require that it be provided access to 271 UNEs at TELRIC prices. *Id.* GWI further argues that the Commission should condition any approval of the Transaction on FairPoint's agreement to provide all of the Section 271 checklist items under the rates, terms and conditions under which they are offered today by Verizon, i.e., TELRIC rates. In the alternative, GWI contends that, at the very least, any approval should be conditioned on FairPoint's agreement not to dispute in any forum that it is obligated to provide section 271 obligations based on its argument that it is not a BOC. GWI Br. at 11.

ii. FairPoint

FairPoint, as discussed earlier, contends that it is not subject to the requirements of section 271 because it is not an RBOC. FP Br. at 81. Assuming the Commission adopts our recommendation, that argument is now moot. FairPoint, however, has voluntarily committed to "provide any item on the 14-point "competitive checklist" set forth in section 271(c)(2)(B) of the federal Communications Act that Verizon would be required to provide under the law, pursuant to the applicable pricing standard adopted by the FCC." FP Br. at 22. In response to an oral data request, FairPoint elaborated on its commitment by specifically stating that it would provide access to: local DS3 and dark fiber transport between the Portland and Bangor wire centers from the trunk side of a wireline local exchange carrier switch unbundled from switching (checklist item (v)); unbundled circuit switching (checklist item (vi)); and non-discriminatory access to databases and associated signaling necessary for call routing and completion (checklist item (x)). FP Resp. to ODR 27.

c. Recommendation

i. Access to 271 UNEs

First, if the Commission adopts our earlier recommendation and finds that FairPoint meets the TelAct's definition of a BOC, there will be no question that FairPoint is obligated to provide CLECs with access to section 271 UNEs. If it does not adopt our recommendation, we still believe that FairPoint should be required to provide CLECs with access to section 271 UNEs. Indeed, FairPoint has voluntarily agreed to such a condition if the Commission approves this Transaction. FP Br. at 22. As with most issues in this proceeding, however, the devil is in the details, i.e., which specific UNEs must be provided, whether these obligations belong in a tariff, whether any agreements to provide section 271 UNEs must be made public, whether TELRIC pricing still has any applicability, and whether the Commission or the FCC will have primary jurisdiction over disputes that arise regarding these obligations.

ii. UNEs Required Under Section 271

Regarding the specific 271 UNEs that must be provided, FairPoint correctly noted that the FCC has explicitly ruled that local loops, transport (including dark fiber), and switching must be provided, even if certain versions of these UNEs are no longer required under section 251. Thus, under current law, FairPoint would be required to provide access to: unbundled switching, DS3 local loops in Portland, DS3 and dark fiber transport between Portland and Bangor. There remain questions, however, regarding the requirements that surround dark fiber loops and line sharing. The First Circuit remanded the Commission's interpretation of those elements back to the District Court for referral to the FCC. *Wholesale Tariff Appeal,* 2007 U.S. App. LEXIS 21349 at 22-23.[51]

We recommend that if the Commission approves this Transaction, it consider imposing a condition explicitly stating that FairPoint must provide access to unbundled switching, DS3 local loops in Portland, DS3 and dark fiber transport between Portland and Bangor as well as any future loops and transport/dark fiber routes that attain non-impaired status under section 251. With regard to line sharing and dark fiber loops, the Commission should explicitly require FairPoint to be bound by the terms of the District Court's Remand Proceeding, including any subsequent ruling from the FCC.

iii. Tariffing of Section 271 Obligations

With regard to whether FairPoint should be required to tariff its section 271 obligations, we find that imposition of such a requirement would only lead to additional litigation. The Commission has spent the last five years litigating the issue of a section 271 tariff. While the recent First Circuit decision did not address this situation in any way, we recommend that the Commission not spend any further resources on this question. Thus, we recommend that the Commission reject the CLEC Coalition's proposed condition to require FairPoint file a section 271 wholesale tariff.

[51] Currently the Remand Proceeding has not begun because Verizon filed a Motion for Panel Reconsideration upon which the First Circuit has yet to rule.

iv. Filing of Commercial Agreements

As for whether any so-called "commercial agreements" between FairPoint and CLECs for section 271 network elements should be made public and/or filed with the Commission, we must first review the case law on this issue. The FCC partially addressed the issue in *In the Matter of Qwest Communications International Inc., Petition for Declaratory Ruling on the Scope of the Duty to File and Obtain Prior Approval of Negotiated Contractual Arrangements under Section 252(a)(1)*, Memorandum Opinion and Order, 17 FCC Rcd 19337 (Oct. 4, 2002). In its Order, the FCC found that any agreement that "creates an *ongoing* obligation pertaining to resale, number portability, dialing parity, access to rights-of-way, reciprocal compensation, interconnection, unbundled network elements or collocations is an interconnection agreement that must be filed pursuant to section 252(a)(1)." *Id*. at ¶ 8. The FCC also found that state commissions were in the best position to decide on a case-by-case basis whether a particular agreement should be considered an interconnection agreement. *Id*. at ¶ 10. Finally, in footnote 26, the FCC noted that it did not believe that all agreements between an ILEC and CLEC would be considered an interconnection agreement, only those involving sections 251(b) or (c).

Not surprisingly, several federal courts have addressed this issue further. Most recently, in *Qwest v. P.U.C. of Colorado*, 479 F.3d 1184 (10th Cir. 2007), the Tenth Circuit upheld decisions by the Colorado and Utah PUCs requiring Qwest to file agreements relating to section 271 elements such as unbundled switching and shared transport pursuant to section 252(a)(1) of the TelAct. The Court found that Qwest's arguments that section 271 contained an independent filing requirement to be "a spurious interpretation of the Commission's Order." *Id*. at 1198. *See Qwest v. P.U.C. of Colorado*, 2006 U.S. Dist. LEXIS 17217 (March 24, 2006); *Qwest v. P.U.C. of Utah*, 2005 U.S. Dist. LEXIS 38306 (Dec. 21, 2005). The First Circuit has not yet addressed this question.

We recommend, based upon both the legal precedent as well as public policy considerations, that the Commission require FairPoint to file copies of any agreements which create ongoing obligations pertaining to "resale, number portability, dialing parity, access to rights-of-way, reciprocal compensation, interconnection, unbundled network elements or collocations" with the Commission. Unbundled network elements include any UNEs which were previously required under section 251 but now are only available pursuant to section 271

We share the CLECs' concerns regarding the potential for discriminatory treatment of carriers, especially with regard to any agreements reached with Verizon affiliates. It remains unclear, despite numerous data requests and questions at the hearings, what the exact nature of the relationship between FairPoint and Verizon (including Verizon affiliates) will be during and after the transition. Accordingly, to ensure fair dealing and no discriminatory behavior, we recommend that the Commission require FairPoint to file copies of any agreements which create ongoing obligations pertaining to "resale, number portability, dialing parity, access to rights-of-way, reciprocal compensation, interconnection, unbundled network elements or collocations" with the Commission for a period of at least three years. At that time, FairPoint may request that the Commission relieve it of this obligation by showing that it has complied with prohibitions against discriminatory behavior over the previous three year period.

v. Pricing of Section 271 Network Elements

Turning to the question of the continued applicability of TELRIC pricing for section 271 network elements, we do not believe this is the right forum for adjudicating GWI's arguments concerning its interpretation of its interconnection agreement. The First Circuit was quite clear that the Commission could not impose TELRIC pricing for section 271 network elements. *Wholesale Tariff Appeal,* 2007 U.S. App. LEXIS 21349 at 16. Further, in addressing the very same argument that GWI makes here, the First Circuit found that the Commission's interpretation of GWI's interconnection agreement seemed to be based upon the assumption that it could impose and set rates for section 271 obligations. *Id.* at 24. The Court went on to say that it read the briefs of both the Commission and Verizon to imply that a decision in Verizon's favor would nullify the GWI ruling. *Id.* Thus, the Court found that, if this were the case, the GWI ruling should be enjoined on remand and that any further arguments related to this issue should be pursued on remand. *Id.* Accordingly, we recommend that the Commission not address GWI's arguments in this proceeding and, instead, address them in the District Court's remand proceeding.

vi. Jurisdiction Over Section 271 Disputes

Finally, concerning the issue of jurisdiction over disputes relating to section 271, if the Commission adopts our earlier recommendation that FairPoint be considered a BOC, then jurisdiction over section 271 disputes will lie with the FCC. We note, however, that the Commission's Rapid Response process, which was established during the Commission's 271 proceeding, allows CLECs to bring complaints regarding wholesale operational issues to specially-appointed Staff who are authorized to resolve the issues on behalf of the Commission. In the past, we have not specifically limited the complaints to matters associated with section 251. Thus, we recommend that the Commission require FairPoint to participate in, and abide by, the Commission's Rapid Response Process, which includes jurisdiction over any operational disputes involving section 271 UNEs. To the extent the parties have purely legal disputes relating to section 271, those disputes should be filed with the FCC. (We note, however, that if FairPoint is willing to submit itself to the Commission's jurisdiction for such disputes, as it has in New Hampshire, the Commission may want to consider imposing such a condition in Maine so that Maine CLECs are not treated differently than New Hampshire CLECs.)

6. PAP & C2C Guidelines

a. Background

As part of Verizon's 271 approval process, Verizon agreed to be bound by Carrier-to-Carrier (C2C) Guidelines and a Performance Assurance Plan (PAP) to ensure that it continued to abide by the market-opening requirements of the TelAct after it gained access to the interLATA market. The FCC reviewed and approved the Maine C2Cs and PAP as part of its approval of Verizon's Section 271 Application. *Application by Verizon New England Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance), NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions), Verizon Global Networks, Inc. and Verizon Selective Services, Inc., for Authorization To Provide In-Region, InterLATA Services in the State of Maine,* CC Docket No. 02-61, Order, 17 FCC Rcd 11676 (2002) at ¶¶ 61-63. The PAP requires Verizon to pay penalties directly to the CLECs if it fails to meet the measures included in the PAP.

b. Positions of the Parties

i. CLECs

The CLECs contend that FairPoint should be required to abide by the PAP as a condition of the Transaction. One contends that FairPoint should not be provided a 60-day grace period after cutover; the PAP should apply throughout the transition period. One Br. at 24. One further points out that the New Hampshire CLEC Settlement provides for only a month-long grace period. *Id.* at fn. 19. The CLEC Coalition agrees with One that the PAP should apply during cutover and transition and also argues that the PAP should be simplified. CC Br. at 25.

ii. FairPoint

FairPoint states that it will abide by the PAP and pay any associated penalties, even if a particular CLEC's interconnection agreement does not explicitly incorporate the PAP. FP Br. at 22; Tr. 10/10/07 at 315-316. FairPoint also states that it will work with the CLECs and the Commission to revise and simplify the PAP following closing. FP Br. at 22. During the hearings, FairPoint witness Haga requested that there be a grace period for the PAP following cutover to the new back office systems. Tr. 10/10/07 at 179-180. Specifically, that FairPoint not be required to measure, report, or pay penalties on PAP measures for 60 days following cutover. *Id*. Later in the day, counsel for FairPoint clarified that FairPoint had not made a formal request for a waiver in this docket but was considering doing so in Docket No. 2000-849, which governs the PAP. *Id*. at 247.

c. Recommendation

We agree with FairPoint and the CLECs that FairPoint should be subject to the terms of Verizon's PAP until such time as the Commission and the parties have time to develop a more simplified version of the PAP. Thus, we recommend that the Commission explicitly condition any approval of the Transaction on such compliance. With regard to the issue of whether FairPoint should be granted a grace period from the PAP during the cutover and transition, we recommend that the Commission not reach that issue in this proceeding and, instead, wait for FairPoint to file a formal request in Docket No. 2000-849 if the Transaction is approved.

7. Special Access Pricing and Volume Commitments

a. Background

In addition to purchasing UNEs from Verizon, many CLECs purchase both interstate and intrastate special access products which are essential to the CLECs' ability to serve their customers. In some instances, Verizon will discount the prices for special access services if the CLEC agrees to purchase certain volumes of those products. Because many CLECs operate in multiple states, the volume commitments often cover multiple states, i.e., CLEC purchases in states A, B, and C would all count toward meeting the commitment. If the Commission approves this Transaction, the NNE states will no longer be part of Verizon and thus the status of volume commitments both within Maine and in other states becomes an important issue for CLECs.

b. Positions of the Parties

i. CLECs

One argues that in order to protect CLECs from FairPoint reneging on volume commitment issues, the Commission should freeze FairPoint's special access rates for three years. One Br. at 27. In addition, One contends that neither FairPoint nor Verizon should be allowed to charge higher special access rates to purchasers under volume-term arrangements because they no longer meet the minimum volume required for a particular discount. *Id*. Thus, One essentially argues that both FairPoint and Verizon should continue to honor all existing special access tariffs "except to the extent that they could exploit diminished economies of scale or scope caused by the transaction." *Id*. Under One's proposed exception, the Commission would require that FairPoint and Verizon offer the same special access discounts as those offered by Verizon today but on proportionate volume levels for the three states and for the remaining Verizon service areas. *Id.*

The CLEC Coalition comments that FairPoint initially offered to freeze special access rates for one year but had recently committed to three years in New Hampshire. CC Br. at 21. The CLEC Coalition contends, however, that even three years is not long enough and requests that the Commission impose a five-year special access rate freeze as a condition to any approval of this Transaction. *Id*. at 24.

ii. FairPoint

FairPoint has voluntarily committed to not withdraw any tariffed interstate or intrastate special access service or seek to increase any of its tariffed rates for interstate or intrastate tariffed special access services effective for three years after the transaction closing, unless required by law. FP Br. at 24. In addition, FairPoint will prorate all volume pricing provided for inter-carrier agreements so such volume pricing terms will be deemed to exclude volume requirements from states outside of the three-state area following the closing. *Id.* In addition, Verizon is contractually bound to make the same type of pro-ration with respect to services CLECs will continue to order in states outside Maine, New Hampshire and Vermont. *Id.*

c. Recommendation

We recommend that the Commission impose as a condition to any approval of this Transaction FairPoint's voluntary commitment to freeze special access rates for three years. We believe such a period is fair and reasonable and that the five years proposed by the CLEC Coalition is simply too long, given the pace of change in the telecommunications marketplace. We also recommend that the Commission include in any conditions it adopts the commitments by FairPoint and Verizon to pro-rate any volume commitments. Such a condition is supported by all parties and will ensure that CLECs are treated fairly by both Verizon and FairPoint.

8. Treatment of MCI Collocations Under the FCC's Impairment Rules

a. Background

In its *Triennial Review Remand Order (TRRO)*,[52] the FCC established rules regarding when incumbent local exchange carriers (ILECs), such as Verizon, must make high capacity loops (DS1 and DS3), dedicated transport (DS1 and DS3) and dark fiber transport unbundled network elements (UNEs) available pursuant to section 251 of

[52] *In the Matter of Unbundled Access to Network Elements; Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, 20 FCC Rcd 2533 (2005) *(TRO Remand Order or TRRO)*.

TelAct. The FCC's rules set objective measures regarding numbers of business lines and fiber-based collocators in individual wire centers. Once the number of business lines and/or fiber-based collocators reaches a certain number, the FCC no longer considers the wire center to be "impaired" and, thus, no longer requires the ILEC to lease certain UNEs pursuant to section 251. When the FCC approved the MCI/Verizon merger it explicitly conditioned its approval on Verizon/MCI excluding fiber-based collocation arrangements established by MCI or its affiliates from the fiber-based collocator wire center counts for impairment purposes. *Verizon Communications Inc. and MCI, Inc. Applications for Approval of Transfer of Control*, WC 05-75, Memorandum Opinion and Order, (rel. Nov. 17, 2005), Appendix G.

b. Positions of the Parties

i. CLECs

Both the CLEC Coalition and One argue in their Brief that the Commission should condition any approval of this Transaction on FairPoint abiding by the three-year commitment it made in New Hampshire to exclude MCI collocations from CLEC collocation counts. CC Br. at 33-34; One Br. at 29.

ii. FairPoint

In his prefiled testimony, FairPoint witness Skrivan stated that FairPoint "may choose to count MCI collocations" for federal impairment purposes because Verizon Maine and MCI will no longer be affiliated if the Transaction is approved, and the FCC's conditions relating to counting collocations should not apply. Skrivan Reb. at 24. He also noted that he did not believe that any wire centers in the state would be immediately impacted by such a decision by FairPoint. *Id.* During cross-examination by the CLEC Coalition, Mr. Skrivan stated that he did not believe CLECs would be any worse off as a practical matter because "this condition terminates for Verizon sometime in the year 2008. And FairPoint is unlikely and probably would be willing to say we're not gonna change any impairment test during 2008 in any case." Tr. 10/10/07 at 285. In the NH Settlement Agreement, FairPoint committed not to count MCI collocations for three years after the closing. NH CLEC Settlement Agreement at 1.d. In FairPoint's Second Comment on the NH CLEC Settlement Agreement, it stated that the same commitment would apply to all CLECs in Maine. *See* FP Br., Appendix D at 2.

c. Recommendation

While it appears that FairPoint and the CLECs are in agreement on this issue, we agree with the CLECs and recommend that FairPoint's three-year commitment not to count MCI collocations be imposed as a specific condition if the Commission approves this Transaction.

9. Wholesale DSL

a. Background

In 2005, the FCC found that, consistent with the Supreme Court's opinion in *NCTA v. Brand X*, facilities-based wireline broadband Internet access service was an information service. *Appropriate Framework for Broadband Access to the Internet Over Wireline Facilities*, Report and Order and Notice of Proposed Rulemaking, 20 FCC Rcd 14853 (2005) at ¶ 5. The FCC then went on to relieve wireline carriers from any obligation to separate out and offer the wireline broadband transmission component (i.e., transmission in excess of 200 kilobits per second (kbps) in at least one direction) of wireline broadband Internet access services as a stand-alone telecommunications service under Title II. *Id*. Thus, so-called wholesale DSL (Digital Subscriber Line) was no longer available to CLECs and other carriers.

b. Positions of the Parties

i. GWI

GWI contends that one of the significant benefits of the proposed Transaction "as touted by FairPoint" is its commitment to expand broadband availability and that no party has argued that such expansion will not be a benefit to the state. GWI Br. at 11. Further, in considering whether the proposed Transaction is consistent with the interests of the utility's ratepayers, GWI argues that the Commission "must not and should not treat the advancement of State broadband interests as advancing the interests of utility ratepayers. Broadband services are not regulated by the State of Maine, and customers of those services are not utility ratepayers within the meaning of Section 708." *Id.* Citing testimony by OPA witness Loube, GWI argues that CLECs may end up in a "price squeeze" on DSL services because FairPoint will be subsidizing its unregulated broadband services with regulated revenues. *Id.* at 12. GWI contends that 35-A M.R.S.A. § 713 provides the Commission with authority to protect CLECs from such a price squeeze. *Id*. Noting that "it may not be practicable" for the Commission to prevent any such subsidies or to limit the amount of broadband investment, GWI argues that "much of the potential damage from the subsidies" could be mitigated if the Commission required FairPoint to sell CLECs DSL services "at wholesale and at prices that reflect FairPoint's savings from the decremental costs avoided by selling at wholesale rather than retail." *Id*. at 13. Until the Commission has time to develop a wholesale rate, GWI suggests using $22 per line. *Id*.

ii. OPA

The OPA argues that despite FairPoint's contention that it does not have any market power in the DSL market, FairPoint witness Skrivan acknowledged on cross-examination that every DSL provider in the state would rely on FairPoint's network in order to deliver any DSL service. *Id*. citing Tr. 10/10/07 at 78. Thus, the OPA also asks the Commission to condition any approval of this Transaction on a requirement that FairPoint provide CLECs with access to wholesale DSL at a reasonable price. OPA Br. at 78. The OPA contends that such a condition will promote broadband competition and development of packages that will benefit consumers. *Id*.

iii. FairPoint

FairPoint contends that the FCC "has ruled unequivocally" that ILECs need only provide DSL on an unregulated basis. FP Br. at 84 citing *Appropriate Framework for Broadband Access to the Internet Over Wireline Facilities*, Report and Order and Notice of Proposed Rulemaking, 20 FCC Rcd 14853 (2005). FairPoint argues that requiring FairPoint to provide wholesale DSL under a tariff is unnecessary "because FairPoint has strong market incentives to develop innovative service offerings at a range of prices designed to meet customers' needs." *Id*. Further, FairPoint states that because none of its competitors, namely the cable companies, would be subject to the same obligation, making FairPoint provide wholesale DSL "would significantly impair its ability to expand the availability of broadband services." FP Br. at 84.

c. Recommendation

It appears that the Commission does not have sufficient evidence before it to warrant a finding that a price squeeze will, in fact, occur. While Dr. Loube has opined that such a squeeze is possible under certain circumstances, we cannot be sure that such circumstances will come to be as hypothesized by Dr. Loube. Further, given that the FCC has directly addressed this matter and found such access unnecessary, we believe the Commission could find itself litigating the matter in federal court if it tried to impose such a condition. Thus, we recommend that the Commission not address this issue in this proceeding. If the Commission approves the Transaction and the CLECs or OPA are later able to come forward with specific evidence that an actual price squeeze is occurring, the Commission could consider potential remedies at that time.

10. Pole Attachments and Pole License Administration

a. Background

On October 26, 2006, the Commission issued its decision in Docket No. 2005-486, *Oxford Networks Request for Commission Investigation into Verizon's Practices and Acts Regarding Access to Utility Poles*. In its Order, the Commission concluded that several of the third-party attachment policies and requirements of Verizon constituted unjust and unreasonable acts, practices and service, that the policies and requirements had impeded the efforts of Oxford Networks to provide competitive telecommunications services, and that the public convenience and necessity required that Oxford have access to utility poles upon reasonable terms and conditions. Order at 1. The Commission went on to direct Verizon to adopt specified alternative policies and procedures for providing Oxford with access to the communication space of utility poles. *Id.*

b. Positions of the Parties

i. CLEC Coalition

The CLEC Coalition contends that while FairPoint has stated that it will abide by Docket 2005-486, it has not shown how they will handle pole administration. CC Br. at 30. The CLEC Coalition is concerned that FairPoint has "not stated where this department will be located, how many will staff this group, who will manage this group, and have not shown it will be staffed with anyone experienced in this function." *Id*. The CLEC Coalition argues that pole administration is very important to all utilities in the state and the costs associated with attaching to poles are a key cost driver in determining whether and where to invest. *Id*. at 31. The CLEC Coalition states that it "has not seen evidence that FairPoint knows, understands, or has planned for a pole administration group." *Id.* Thus, the CLEC Coalition argues that if the Commission approves the Transaction, it should require FairPoint to establish and staff a license administration group prior to closing to handle pole and conduit license administration functions in the same manner as Verizon currently handles pole and conduit license administration functions. *Id*. at 32.

ii. FairPoint

FairPoint states that it will provide access to poles as required by state and federal law and that it will abide by the Commission's decision in Docket No. 2005-486. FP Br. at 78; Lippold Reb. at 20. During the hearings, however, FairPoint witness Lippold stated that the License Administration Group would not be part of the Wholesale Operations Group but instead would be with the Operations Group under Mr. Smee and would be located in Portland. Tr. 10/10/07 at 78. Mr. Lippold did not know how many persons would be in the License Administration Group. *Id*. He also stated that he did not have any personal knowledge regarding how quickly pole attachment applications would be processed. *Id*.

c. Recommendation

We agree with the CLEC Coalition regarding the importance of pole administration and the need for FairPoint to abide by the Commission's rulings in Docket No. 2005-486. We also agree that FairPoint has not yet provided any details regarding how it will handle this important function. In addition, we find that while FairPoint subsidiaries may have experience in pole administration in their individual territories, FairPoint has not likely experienced the volume and scope of work that will be expected of it in the NNE states.

It appears that pole administration functions are covered under the TSA. This being the case, FairPoint has until at least May of 2008 before it will be required to take over these responsibilities. Accordingly, if the Commission approves the Transaction, we recommend that it require FairPoint to file a monthly status report regarding its progress in putting together the Pole Licensing and Administration Group and ensuring that its employees are fully ready and capable of assuming those responsibilities. We also recommend that the Commission set April 1, 2008, as the deadline for FairPoint to be ready to assume pole licensing and administration duties.

11. Forbearance

a. Background

Under section 10(a) of the TelAct (47 U.S.C. § 160), the FCC is required to forbear from applying any regulation or provision of the TelAct if it finds that enforcement is not necessary to ensure that "charges, practices, classifications, or regulations" are not unjustly or unreasonably discriminatory, enforcement is not necessary for the protection of consumers, and forbearance is consistent with the public interest, including the impact on competition. Section 10(c) states that any carrier can petition the FCC for forbearance while section 10(d) limits the FCC from forbearing on the requirements of section 251(c) or 271 until it determines that those requirements have been fully implemented. 47 U.S.C. § 160(c) and (d). Finally, according to section 10(e), a state commission cannot apply or enforce any regulation or statute once the FCC has made a decision to forbear. 47 U.S.C. § 160(d).

Currently, Verizon has a petition pending before the FCC seeking forbearance from: (1) the obligation to provide unbundled loops and dedicated transport pursuant to section 251(c)(3) in those portions of its service territory in the Boston Metropolitan Statistical Area (MSA) where a facilities-based competitor has substantially built out its network; (2) application of certain dominant carrier regulation to Verizon's provision of mass market switched access and broadband services in Verizon's service territory; and relief from sections 271 and 251(c)(6) only to the extent it reflects any relief granted from section 251(c)(3). *See Petition of Verizon Telephone Companies for Forbearance Pursuant to 47 U.S.C. §160(c) in the Boston Metropolitan Statistical Area*, filed Sept.6, 2006.

b. Positions of the Parties

i. CLECs

Both One and the CLEC Coalition accept FairPoint's commitment but ask that it be made a mandatory condition of any Commission approval of the transaction.

ii. FairPoint

In its Brief, FairPoint committed "to refrain from seeking certain forbearance relief from the FCC for three years following closing of the transaction." Br. at 87. This commitment arises out of the NH CLEC Settlement and is listed by FairPoint as one of the provisions that will automatically apply to Maine. FP Br. at Appendix D.

c. Recommendation

We find that forbearance by the FCC of section 251 or 271 obligations in Maine could have a negative impact on competition. Accordingly, we recommend that the Commission grant the CLECs' request to make FairPoint's three-year commitment to refrain from filing for forbearance a condition to any approval of this Transaction.

12. Summary of Proposed Conditions

As stated earlier, the Examiners remain concerned with FairPoint's ability to meet the needs of Maine's wholesale customers. Given the lack of experience and the speed with which FairPoint will be expected to assemble its staff and systems, we expect there will be glitches in the system – as there were with Verizon when it was developing its wholesale systems. The conditions recommended in this Section are intended to help FairPoint and the CLECs avoid some pitfalls and to mitigate any negative effects caused by the transition if the Commission approves the Transaction.

VI-A-1	Consider FairPoint to be a successor and assign of Verizon and, therefore, subject to the requirements of section 271 as well as all other obligations applicable to BOCs.
VI-A-2	Require FairPoint, upon request, to extend all the terms of its interconnection agreements by at least two years.
VI-A-3	Require FairPoint to file an updated version of Verizon's wholesale tariff within a year of closing.
VI-A-4	Require FairPoint to abide by section 251 and impose a three-year freeze on section 251 UNE rates.

VI-A-5	Prohibit FairPoint from seeking either a section 251(f)(1) or 251(f)(2) exemption.
VI-A-6	Require FairPoint to provide access to unbundled switching, DS3 local loops in Portland, DS3 and dark fiber transport between Portland and Bangor as well as any future loops and transport/dark fiber routes that attain non-impaired status under section 251.
VI-A-7	Require FairPoint to abide by the terms of the District Court's Remand Proceeding as it relates to line sharing and dark fiber loops.
VI-A-8	Require FairPoint to file copies of any agreements which create ongoing obligations pertaining to "resale, number portability, dialing parity, access to rights-of-way, reciprocal compensation, interconnection, unbundled network elements or collocations" with the Commission for a period of at least three years.
VI-A-9	Require FairPoint to participate in, and abide by, the Commission's Rapid Response Process, which includes jurisdiction over any operational disputes involving section 271 UNEs.
VI-A-10	Require FairPoint to abide by the terms of Verizon's PAP until FairPoint and the CLECs develop a more simplified PAP.
VI-A-11	Require FairPoint to freeze access rates for three years.
VI-A-12	Require both FairPoint and Verizon to pro-rate any volume commitments related to wholesale services.
VI-A-13	Prohibit FairPoint from counting MCI fiber-based collocations for impairment purposes under section 251 for a period of three years.
VI-A-14	Require FairPoint to file a monthly status report regarding progress in putting together the Pole Licensing and Administration Group and set April 1, 2007 as the deadline for FairPoint to be ready to assume pole licensing and administration duties.
VI-A-15	Require FairPoint to refrain from filing petitions for forbearance with the FCC for a period of three years.

B. Back Office Systems

1. General Background

Back office systems are defined as the centralized systems and processes used to operate telecommunications businesses. Haga Dir. at 4. Mr. Haga, on behalf of FairPoint, segregates back office systems into two, high-level categories: (1) business *processes*; and (2) business *systems*.

1. Business Processes
"...the various methods, procedures, work tasks, and associated inputs and outputs that employees use to conduct our business and provide our services and products to our retail and wholesale customers. Examples

include taking a customer order, engineering an outside plant addition, or monitoring network performance." Haga Dir. at 4.

2. Business Systems
"…the software, hardware and interfaces that are the primary tools used to execute the business processes. Business systems are the tools that make business processes work." Haga Dir. at 4

Verizon currently uses 617 distinct applications to support its business processes. Tr. 10/04/07 at 275. However, Mr. Haga is quick to point out that those 617 applications do not equate to 617 different systems. According to Mr. Haga, many of Verizon's existing applications are actually "sub-systems" supported by the same overarching system. Haga/Kurtze Reb. at 23. FairPoint groups Verizon's multiple applications into approximately 50 different systems as follows:

	System Description	Existing Verizon Systems	Cite
1.	Billing Systems (5)	CRIS, BCRIS, Arbor, CTIM and NBBE	Haga/Kurtze Reb. at 11
2.	Ordering and Customer Care Systems (at least 9)	DOE, SOP, ICRIS, BOSS, QuickSuite, Netstatus, COPS/SSB, CXO and InfoPro	Haga/Kurtze Reb. at 12
3.	Enterprise Management	Systems for Finance, Human Resources, Payroll, Accounts Payable, Accounts Receivable, Real Estate, Supply Chain and Risk Management.	Haga/Kurtze Reb. at 14
4.	Wholesale Support (4 systems for IXCs, 3 systems for CLECs)	EB, VTAG, TAXI, Access, RETAS, TAXI Local and TADI.	Haga/Kurtze Reb. at 16
5.	Bill Mediation (2)	AMA and STARMEM	Haga/Kurtze Reb. at 18

6.	Inventory Provisioning and Activation (7)	AWS, SOAC, MARCH, SWITCH, TIRKS, LFACs and eWPTS	Haga/Kurtze Reb. at 19
7.	Network Planning and Design (4)	FEPS, ECRIS, FACS and Foresight	Haga/Kurtze Reb. at 20
8.	Network Engineering (4)	Backstop, Opera, CCP and COEP	Haga/Kurtze Reb. at 20
9.	Fault Management (2)	Delphi, React	Haga/Kurtze Reb. at 21
10.	Security Management	IFAS, Access Guardian	Haga/Kurtze Reb. at 22
11.	Work-Force Management (3)	Dispatch, WFA and CBSCNE	Haga/Kurtze Reb. at 22
12.	Performance Monitoring (2)	NMA and NMP	Haga/Kurtze Reb. at 22

If the Transaction is consummated and FairPoint takes over the Verizon network and operations, FairPoint does not intend to rely upon Verizon's existing back office systems or processes. Haga Dir. at 4-6. Instead, FairPoint has hired Capgemini U.S. LLC (hereafter "Capgemini") to build, from scratch, state-of-the-art processes and systems that will support the entirety of FairPoint's New England operations (i.e., Maine, New Hampshire and Vermont). Haga Dir. at 6. FairPoint estimates that it will pay Capgemini approximately $200 million for "systems development and integration" throughout the rebuild process. FP Br. at 47. FairPoint will not, however, begin using its new systems immediately following the close of the Transaction.

Immediately following the close of the Transaction, estimated to be January 31, 2008, Verizon will continue to make its business systems and processes available to FairPoint through a Transitional Services Agreement (TSA). Verizon Br. at 5. The TSA will put Verizon in the role of a "service bureau" responsible for supporting FairPoint's communications businesses until its new systems are developed, tested and ready for use. FairPoint will pay Verizon approximately **BEGIN CONFIDENTIAL** _______**END CONFIDENTIAL** per month for each month it must rely upon the TSA, plus an estimated $34 million when it finally performs a flash-cut between Verizon's systems and its newly developed systems (what has been described as the "cutover").[53] ADV. Ex. 3 and Smith Dir. at 29. At this time, FairPoint intends to cutover from the Verizon systems to its newly designed systems on May 30, 2008, thereby relying upon Verizon's TSA for a total of four months. FP Br. at 47; ADV. Ex. 3. It is anticipated that FairPoint will pay Verizon approximately **BEGIN CONFIDENTIAL** _________**END CONFIDENTIAL** for use of TSA-related services between the anticipated closing date (January 31, 2008) and the cutover (May 30, 2008). ADV Ex. 3.

2. Positions of the Parties

a. FairPoint

FairPoint describes its back office system overhaul as "an opportunity [for the State of Maine] to fundamentally update the back office systems serving telephone customers, both retail and wholesale." FP Br. at 46. Mr. Haga opines, on behalf of FairPoint, that the new systems will be less expensive to operate and will increase FairPoint's flexibility in introducing new services with increased efficiency. Haga/Kurtze Reb. at 48. Indeed, FairPoint argues that the newly developed systems "…will have a direct positive impact on quality of service, as well as on the economy and is thereby consistent with the interests of the ratepayers." FP Br. at 46. According to FairPoint, the new systems will be superior to Verizon's legacy systems, to the point that Mr. Smith, on behalf of Verizon, has stated that Verizon would be envious of the new

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[53] The TSA is structured around five separate schedules and the actual price per month fluctuates over time. *See* ADV. Ex. 3 for additional detail.

systems. FP Br. at 46. Finally, FairPoint argues that much of the back office activity that Verizon has moved to centralized locations outside of New England over the past years will be returned to New England as part of the new FairPoint systems and service centers, thereby further benefiting citizens of the three New England states. FP Br. at 46.

With the combined expertise of its own staff and Capgemini's substantial assistance, FairPoint believes it possesses the technical capabilities necessary to accomplish the enormous undertaking embodied in the back office rebuild it has planned. Haga Dr. at 4-6. In support of this point, FairPoint touts the substantial experience of Capgemini's various consultants, including Mr. Kurtze, the project's Senior Advisor who has more than 40 years of telecommunications management experience including a stint as Sprint PCS's Chief Operating Officer at the time it developed the information technologies necessary to support its business. FP Br. at 47. Likewise, FairPoint points to its own, and Capgemini's, previous experience with developing telecommunications business processes and systems, including Capgemini's construction of billing systems for one unnamed local exchange carrier affecting 3 million customers. FP Br. at 47.

FairPoint contracted with Capgemini as its systems development vendor on January 15, 2007, before the Transaction documents between Verizon and FairPoint were signed - a little more than one year prior to the intended closing of the Transaction and sixteen months in advance of the planned cutover. Haga/Kurtze Reb. at 7 and Conf. Ex. H/K-16. FairPoint points to this type of preparedness as an indication of its commitment to the transition process, as well as an indication of its anticipated success.

FairPoint highlights its foresight in this regard to contrast its systems development initiative from a similar endeavor undertaken by a previous Verizon transaction partner, Hawaiian Telcom, whose similar systems development efforts were plagued with problems. FP Br. at 48. In answer to its critics, who point to the Hawaiian Telcom situation and foretell similar woe with FairPoint's effort, FairPoint points out that it will have been, at the time of cutover, developing and testing its systems and processes for seventeen months, whereas Hawaiian Telecom provided itself only a nine-month window prior to its anticipated cutover for the same number of systems. FP Br. at 48. FairPoint highlights the fact that there are still seven months between the writing of its Brief and the intended cutover date, yet FairPoint "has already completed the initial development of all of its systems, created a Cutover Task List and a detailed Testing Strategy for the cutover." FP Br. at 48, citing Tr. 10/10/07 at 190-191.

To further separate itself from Hawaiian Telcom's problems, FairPoint highlights the testimony of Mr. Smith from Verizon, who was involved in the Hawaii transaction and the subsequent back office systems transition. FairPoint points out that Mr. Smith has described the differences between FairPoint's approach and Hawaiian Telecom's approach as "night-and-day." Indeed, FairPoint notes that Mr. Smith described FairPoint's systems development initiative as "the best managed process I've ever witnessed." FP Br. at 52 citing Tr. 10/4/07 at 326.

Even though it believes it is in far superior shape to Hawaiian Telcom prior to its cutover from Verizon's systems, FairPoint acknowledges that with any cutover exercise, error-related risks exist and must be managed. Haga/Kurtze Reb. at 32. FairPoint points to its "effective testing plan" as the "primary safeguard" intended to mitigate those risks in this circumstance. FP Br. at 49. Mr. Kurzte, on behalf of FairPoint, explains that testing will occur in stages prior to cutover, with testing done first at the individual application level, then to groups of applications, and finally culminating in "end-to-end testing." Following these application-specific tests will be "load testing," whereby the systems and applications are tested with substantial transactional volume to ensure they can handle not only the functionality, but the "load" of day-to-day operations. Finally, FairPoint will engage in "user acceptance testing." Haga/Kurtze Reb. at 33 According to Mr. Kurtze, "years of data will work its way through the system" during these various testing processes, and over 200,000 person hours will be dedicated solely to the testing process prior to cutover." Haga/Kurtze Reb. at 33; FP Br. at 49 citing Tr. 10/10/07 at 216.

FairPoint explains that its entire testing process will be formalized in a Test Strategy document. However, in an effort to increase the comfort level of regulators regarding the effectiveness of its testing strategy, and ultimately its readiness to undertake the "flash-cut"[54] cutover, FairPoint offers to fund a third-party consultant, already contracted by one of the three relevant state commissions, to review and observe the testing process through its fruition at cutover. FP Br. at 50. The third-party consultant will be available to consult with the three Commissions on FairPoint's Test Strategy and to coordinate with FairPoint so as to provide transparency to the testing and cutover process. However, FairPoint makes clear that the role of the consultant "should be limited to exclude any role in the development of systems or any assessment of FairPoint's 'operational readiness.'" FP Br. at 50.

[54] "Flash cut" means that all systems should be cutover from Verizon to FairPoint simultaneously.

FairPoint, in its Brief, points out that the third-party consultant process it described first in the rebuttal testimony of Mr. Haga and Mr. Kurtz is under way, with the three state commissions having chosen a consultant to serve in this role. Likewise, FairPoint points to the fact that the NH PUC on October 29, 2007 issued a Statement of Work that would govern the consultant's role in the testing and cutover process. FP Br. at 48. According to FairPoint, this process should provide the Commission additional comfort that the cutover will go smoothly, and that ultimately, Maine's citizens will transition to its new systems at cutover with very few, if any, problems.

FairPoint does not agree with parties who suggest that the cutover should, or could, be effectively undertaken in stages to minimize risks of error (i.e., cutting over different groups of systems or different states at different times), or that FairPoint could effectively revert back to Verizon's TSA services post-cutover in the event of systems or process problems. Haga/Kurtze Reb. at 30-32. Indeed, FairPoint argues that it considered all of those options and rejected them in favor of a "flash-cut" process, because the "flash-cut" presented the least risk. Haga/Kurtze Reb. at 30-32. Mr. Haga opined that after discussions with Capgemini and Verizon on the issue, it is his opinion that "the flash cut is the best avenue" and "remains the only viable alternative." Haga/Kurtze Reb. at 32.

Finally, FairPoint insists that transitioning its wholesale customers to its new systems will benefit those customers, in spite of concerns raised by many of its CLEC customers, who are concerned that the new systems will cause them operational problems. FP Br. at 51. FairPoint insists that it is building its customer-facing systems to industry standards that the CLEC community is well aware of and that there should be few, if any, problems in that regard. FP Br. at 51. Further, FairPoint argues that because it is building its interfaces directly to standards already employed by the industry, modifications required of Maine's CLECs in order to interact with the new systems, and hence resultant costs, should be minor. Tr. 10/10/07 at 130. Finally, FairPoint highlights the fact that it has already undertaken orientation sessions with its potential CLEC customers who will rely upon its WISOR interface and intends to meet with its single, Maine-based customer relying upon a direct, Electronic Data Interchange "EDI" interface by October 31, 2007. FP Br. at 51.

In summary, FairPoint notes that it has devised "comprehensive planning, implementation, testing and risk mitigation strategies to ensure cutover will be successful." FP Br. at 52. Further, FairPoint notes again that following the successful cutover, FairPoint will be working with state-of-the-art systems that will have a direct and positive impact on its quality of service and its ongoing cost structure thereby benefiting the interest of its many wholesale and retail ratepayers. FP Br. at 52.

ii. Verizon

Verizon also believes that the processes currently being implemented by both itself and FairPoint in preparation for the cutover are comprehensive and closely coordinated towards assuring a seamless conversion. VZ Br. at 7. Verizon highlights the fact that it, along with FairPoint and Capgemini, have deployed "massive resources" toward jointly managing the planning and preparation processes for cutover, starting with Joint Cutover planning sessions that began in January 2007 soon after the Transaction was announced. Since that time, according to Verizon, a joint Cutover Planning Committee comprised of the senior leaders of all three companies has met weekly. VZ Br. at 7. Further, the parties have undertaken several multi-day meetings and workshops to discuss a multitude of specifics related to FairPoint's systems development processes and the Verizon data that will play such a key role in FairPoint's business going forward. VZ Br. at 8.

Verizon indicates that there are nearly 1,600 different cutover steps, broken down into 130 subject areas, necessary to complete the cutover successfully. The parties have jointly developed two overarching planning documents which describe the specific actions that both parties must take with respect to each cutover step and provide a schedule for completion: (1) the *Cutover Preparation Tasks* list authored primarily by FairPoint; and (2) Verizon's *Cutover Plan*. VZ Br. at 8. According to Verizon, these two documents envision two full tests of the cutover process in the form of "dry runs" in which "Verizon will deliver to FairPoint full data extracts from its 'golden source' systems that provide the electronic data FairPoint will need to operate the business." VZ Br. at 8.

The purpose of these exercises is to test Verizon's aptitude in pulling and transferring the proper data and to test FairPoint's readiness and ability to receive and use the data. After each such extract and test, Verizon and FairPoint will meet with Capgemini to discuss the test and any difficulties FairPoint encountered in converting and uploading the data. VZ Br. at 9. These meetings are meant to provide lessons that will be used to improve the second and final extract processes at cutover.

At the time of the Maine hearings in early October, Verizon reported that the parties recently completed the first data extract and dry run. Verizon describes the result as "for the most part…successful," pointing in part to the testimony of Mr. Kurtze at the hearing who identified, according to Verizon, only "a few formatting issues" which Verizon has already addressed. VZ Br. at 9. Verizon also seems pleased with FairPoint's performance during the process so far, indicating that, "As of the conclusion of the Maine hearings, FairPoint had met 100% of its major Cutover milestones on deadline, and was on time or ahead of schedule for 98-99% of the deadlines for the underlying smaller tasks." VZ Br. at 9 citing Tr. 10-10-07 at 213-14.

Verizon tackles the issue of Hawaiian Telcom and the problems encountered in that transaction head on, arguing that the lessons it learned in Hawaii have helped it approach this initiative in a more educated fashion. VZ Br. at 11. Verizon contrasts the working relationship it has with FairPoint and Capgemini with the relationship it had with Hawaiian Telcom, with Mr. Smith describing FairPoint's preparation for cutover as "night and day" to that he witnessed in Hawaii. VZ Br. at 11, citing Smith Reb. at 10.

Further, Verizon points out that there are important differences between FairPoint and its transaction partner in Hawaii. The transaction in Hawaii involved a private equity firm that assembled a management team from scratch during the review process and throughout closing and cutover. In contrast, Verizon notes that FairPoint is an experienced telecommunications operator who has substantial experience acquiring rural landline telephone operations, and who has been engaged in the back office rebuild project since the very beginning of the Transaction (compared to Hawaiian Telcom who did not retain a consultant until five months after the documents were signed). VZ Br. at 11-12. Further, Verizon points out that it has a "far higher level of communication and coordination [with FairPoint] than existed in Hawaii, including the creation of the FairPoint Cutover Preparations Tasks and significant test data extract feedback." VZ Br. at 12. As a result, Verizon has a far better understanding of the systems FairPoint intends to deploy giving Verizon better insight, upfront, into potential compatibility problems. VZ Br. at 12.

Finally, like FairPoint, Verizon points to the formalized structure of the cutover, including testing, as an important tool in identifying and rectifying potential problems. Verizon explains that FairPoint must, pursuant to the terms of the TSA, submit to Verizon a "Notice of Readiness" notifying Verizon of its official intention to cutover from the TSA services to its own systems. VZ Br. at 9. Upon receipt of the Notice, Verizon indicates that Mr. Smith will, on Verizon's behalf, poll Verizon's numerous subject matter experts involved in the transition to identify any concerns they may have about FairPoint's readiness for cutover. While Verizon notes that FairPoint has sole authority to execute the cutover, if problems were identified in Mr. Smith's review, Mr. Smith would contact Mr. Nixon directly to discuss any issues that arise. VZ Br. at 10.

According to Verizon, "This approach, combined with (1) third-party monitoring of FairPoint's OSS development and (2) FairPoint's recognition that a premature cutover would result in customer dissatisfaction and loss of marketing opportunities substantially in excess of any potential savings of TSA fees (Haga/Kurtze Reb. at 44), provide strong evidence that a premature Cutover is not a valid concern." VZ Br. at 10. As a result, Verizon assures the Commission that at the end of the day, "…the comprehensive Cutover Plan and Preparation Tasks, the enormous amount of planning and preparation work by Verizon and FairPoint, the multiple tests in the form of data extracts and the timing of the cutover itself are all designed to ensure a seamless cutover at the appropriate time." VZ Br. at 11.

iii. OPA

The OPA likens Verizon's sale of its NNE properties without supplying the necessary back office systems and processes necessary to run them, as selling "a car without the engine." OPA Br. at 45. The OPA asserts that "FairPoint is not buying a 'turn-key' operation….[i]nstead, in order to provide telephone service in Maine, New Hampshire and Vermont, FairPoint will first have to invest substantial sums to build up the management and support services necessary to operate the NNE exchanges as a stand-alone telephone company." OPA Br. at 45. As a general matter, the OPA raises this issue to support its argument that the financial arrangements of the Transaction are unfavorable to ratepayers and that, contrary to FairPoint's assertions, it is not getting a "good deal" in this Transaction. OPA Br. at 45-46. However, the OPA also raises numerous concerns about the back office rebuild in general, and highlights a number of potential risks that the cutover could have on service quality. OPA Br. at 59. Ms. Alexander summarizes OPA's overarching concerns related to service-quality in the following way: "The concern is highlighted by FairPoint's plan to change every software system currently used by Verizon to take orders, install service, monitor the network, and bill and collect for services." OPA Br. at 59, emphasis in original. According to the OPA, "[j]ust one significant failure in just one of these categories can have a strong negative impact on service quality." OPA Br. at 59.

OPA's concerns related to service quality impacts resulting from the cutover are heightened both by Verizon's experience in Hawaii, discussed earlier, and FairPoint's own problems with a billing system transition it attempted in 2005. According to Ms. Alexander, FairPoint's billing system conversion in 2005 resulted in billing failures, increased customer complaints, and deterioration in call center performance, thereby highlighting the service quality risks that can result from changes of the type envisioned on a much larger scale by FairPoint via this Transaction. Alexander Dir. at 26.

The OPA is concerned that both FairPoint and Capgemini lack experience with a systems cutover initiative of this magnitude. Furthermore, given the integrated nature of the systems that will be cutover, in combination with the risks FairPoint admits can arise from such an endeavor, the OPA is disappointed that FairPoint has not undertaken a formal risk analysis meant to identify specific risks and thereafter devise steps needed to avoid those potential problems. OPA Br. at 60. For this reason, the OPA recommends that the Commission attempt to mitigate potential risks for ratepayers by placing the risk of failure directly upon FairPoint's shareholders. OPA Br. at 60. To this end, the OPA recommends that the service quality conditions and performance standards recommended by Ms. Alexander in her Direct Testimony, and discussed in the Service Quality section of this Report, are well suited to shift risks from ratepayers to shareholders. OPA Br. at 60 referencing Alexander Dir. at 33-36.

OPA sees additional risks inherent in the back office transition beyond those that might result in service quality problems. OPA sees the "extremely high costs of the TSA" as an additional risk to ratepayers, and argues that Verizon, as a result of its petition to abandon service in Maine, should bear some responsibility of those risks. OPA Br. at 61. OPA argues that many risks associated with possible service deterioration during cutover can be transferred from ratepayers to Verizon by requiring Verizon to "…reduce substantially the charges under the TSA" and further, by requiring

Verizon to "be responsible for all important systems until their successful cutover to FairPoint's control." OPA Br. at 62.

iv. Labor

Like the OPA, Labor refers the Commission to Verizon's Hawaiian Telcom transaction as well as to FairPoint's less-than-seamless billing conversion in 2005 as evidence that it should be highly concerned by the back office systems rebuild FairPoint intends to undertake. Labor Br. at 31-32. Labor points out that there are significant similarities between the Hawaii transaction and this Transaction. Specifically, Verizon is selling its landline exchanges to a highly leveraged firm that lacks experience with an operation of this size. Further, the buyer will need to develop and integrate entirely new operating and support systems but until it is able to do so, must rely upon Verizon's TSA agreement. Labor Br. at 33. While these similarities are reason enough for concern, Labor argues that one important difference is also crucial, i.e., "the Carlyle Group [who purchased the Hawaiian Telcom assets] had major financial resources it could extend to Hawaiian Telcom if it so desired, FairPoint will not have access to such resources." Labor Br. at 33. Labor concludes that: "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." Labor Br. at 34.

v. CLEC Coalition

The CLEC Coalition is concerned that FairPoint is rebuilding back office systems without the extensive independent third-party testing that took place before Verizon was granted section 271 authority. CC Br. at 26. This concern is heightened by FairPoint's insistence that third-party testing is not required for the systems it will develop and employ in lieu of Verizon's systems. CC Br. at 28. In short, the CLEC Coalition argues that "[w]hile the CLEC Coalition is not enamored with Verizon's current OSS, [at least] CLECs [currently] have working arrangements in place." *Id.*

The CLEC Coalition also expresses concerns about FairPoint's ability to "grow from a relatively small company to the largest ILEC in the region," while at the same time completely rebuilding the necessary systems to run the business, especially those systems that also support CLEC businesses. CC Br. at 27. Indeed, the CLEC Coalition expresses concerns that there is a very "real risk that FairPoint will, in the best case, fail in this endeavor, dragging down the CLEC Coalition companies and retail customers with them." CC Br. at 25.

In an effort to mitigate these risks, the CLEC Coalition asks the Commission to require FairPoint to submit its newly designed back office systems to rigorous testing by an independent entity before it is allowed to be deployed to CLECs. The CLEC Coalition appears to believe that the third-party monitoring role to be provided by Liberty Consulting on the part of the three affected state commissions could suffice in this regard, as long as it is codified as a formal condition of the merger.[55] CC Br. at 29. Finally, the CLEC Coalition argues that, as part of its recommendation that all wholesale rates be frozen for five years, FairPoint should be prohibited from recovering costs associated with the Transaction, including back office related costs, from CLEC rates. CC Br. at 21.

[55] See ADVI Ex. 338 for the current Scope of Work related to Liberty Consulting's role in monitoring FairPoint's testing process and overall readiness.

vi. GWI

GWI points out that for carriers, like GWI, who interact with Verizon through a direct, computer-to-computer interface (i.e., Electronic Data Interface - "EDI"), FairPoint's calculation of its costs to rebuild back office systems to replace those used by Verizon "is only part of the relevant equation." GWI Br. at 14. GWI argues that it will also be required to expend resources to modify and develop its own systems so as to be useable with FairPoint's new systems. GWI Br. at 14. Further, GWI is not convinced to the same degree as FairPoint's witness Mr. Lippold is, that these expenses are likely to be small, equaling only about 40 person-hours. GWI contrasts this estimate with the estimate of Mr. Kittredge who suggested that GWI had invested approximately 12 person-years in developing its existing interface with Verizon. GWI Br. at 14. In light of its fear that expenses associated with rebuilding to the FairPoint system could be substantial, GWI asks the Commission to condition any approval of the Transaction on the requirement that FairPoint compensate CLECs for their reasonable costs relating to modifications and additional systems development. GWI Br. at 14. According to GWI, if those expenses equaled only the 40 person- hours estimated by Mr. Lippold, "then there is no issue." *Id.* GWI would not seek reimbursement for expenses of that magnitude. *Id*. However, if GWI's reasonable expenses were substantial, it should be provided the opportunity for compensation from FairPoint as those expenses would be directly caused by the Transaction. GWI Br. at 14-15.

vii. One

Without a requirement that FairPoint's new back office systems be subjected to the same rigorous third-party testing that Verizon's back office systems were subject to during the 271 process, One fears that CLECs could end up worse-off with FairPoint's new systems than they were under Verizon's old systems, in terms of non-discriminatory access. One Br. at 22. One is also concerned that with the TSA's $14 million per month price tag, FairPoint will have a powerful incentive to discontinue its use of Verizon's TSA services at the time of the planned cutover, regardless of its actual readiness, thereby exacerbating potential problems. One Br. at 22. All of this, combined with its concerns that FairPoint would, in a time of crisis, respond more quickly to its own retail customers than to its wholesale customers, compels One to ask the Commission to place the following conditions on any approval it may grant in relation to the proposed Transaction:

(1) The Commission should require FairPoint to follow through on its commitment to allow Liberty Consulting, working on behalf of the three state commissions, to closely monitor its testing and preparation activities and report on its readiness for cutover. According to One Communications, Liberty Consulting's conclusions should be made public and subject to notice and comment by the parties, and the three state commissions should be required to approve FairPoint's readiness before cutover could be initiated. One Br. at 24.

(2) The state commissions should retain the authority to stop the cutover, even after the notice of readiness has been given to Verizon, in the event that further testing indicates a delay is necessary. One Br. at 24.

(3) FairPoint's request to suspend the PAP for 60 days following the cutover should be rejected. One Br. at 24.

(4) Wholesale customers should not be forced to incur extra expenses as a result of inefficiencies created by the Transaction or to reimburse FairPoint, via wholesale rates, for any costs associated with the adoption of new back office systems. According to One Communications, these types of extra expenses would include training costs that FairPoint may try to assess on wholesale customers who require training to interact effectively with FairPoint's new systems or expenses CLECs might incur to

> develop their own OSS interfaces or other OSS features necessary to interface with FairPoint's new systems in a manner consistent with using Verizon's systems today. One Br. at 25.

2. Recommendation

Substantial time and effort were focused during this proceeding, in workshops as well in testimony, discovery and at hearing, on FairPoint's effort to rebuild back office systems to replace Verizon systems that will not be transferred with the remainder of its NNE operations. Indeed, nearly every party other than FairPoint and Verizon raise concerns related to risks they foresee in FairPoint's systems rebuild effort. It is undisputed in the record that FairPoint's back office systems, or Verizon's systems for that matter, impact every aspect of FairPoint's ability to provide services and support its customers. Further, it is clear that rebuilding systems capable of replacing Verizon's existing systems and processes is an enormously complex and expensive initiative, fraught with potential risks and problems, both in concept and in execution.

However, it is also clear that such risks are not without potential rewards. We agree with FairPoint that, if done correctly, replacing Verizon's legacy systems with state-of-the-art technology could result in systems that are notably superior to those operated by Verizon today. FP Br. at 46. We also agree that new systems could provide FairPoint some much-needed flexibility that would help it respond to customer requests and bring products to the marketplace more quickly and easily. *Id*. For these reasons, we believe that when considered in total, FairPoint's new systems should be seen by the Commission as a potential benefit of the Transaction. However, we stress strongly that we believe those potential benefits could quickly and easily turn to devastating disadvantages if the systems are utilized before being properly tested and proven capable of doing the job.

Multiple parties pointed to the experiences of Hawaiian Telcom as a cautionary tale that the Commission should consider before approving the Transaction. *See* OPA Br. at 46-47, Labor Br. at 32, CC Br. at 27, etc. We believe the Hawaiian Telcom example is most informative in understanding the ramifications of a development process that is not adequately funded, managed, and/or tested prior to cutover and we believe those ramifications are daunting enough that they should be avoided at nearly any cost. As such, we believe issues discussed below related to proper cutover planning, testing, monitoring and funding should be of paramount importance to the Commission when considering this specific topic as well as the Transaction in general.

We believe that FairPoint is far better prepared than Hawaiian Telcom was and we derive considerable comfort in the depth and consistency of the development process FairPoint and Verizon have undertaken so far. We find credible Mr. Smith's testimony concerning the difference in approach undertaken by FairPoint and that he expects the results to be similarly disparate. Tr. 10/04/07 at 349-350. Accordingly, we believe that, with the conditions described below, combined with a vigilant monitoring process, Maine can avoid the obstacles that have apparently plagued the Hawaiian marketplace.

a. <u>TSA</u>

The OPA has, in our opinion, squarely captured the issues surrounding FairPoint's back office system development with its analogy of Verizon selling "a car without the engine." OPA Br. at 45. Without effective back office systems, the business of accepting and fulfilling orders, billing and recovering revenues, maintaining the network, and hundreds of other critical, revenue producing functions simply are not possible. Proof of this can be found simply by reviewing the breadth of the TSA that will be necessary to support FairPoint's business immediately following closing until it is able to cutover to its own systems.[56] Smith Dir., Ex. SES-4. Further, Mr. Smith admits that it is the integrated nature of Verizon's existing systems and the fact that they support many Verizon affiliates, in addition to Verizon Maine, that, in part, requires those systems not be conveyed to FairPoint as part of the Transaction. Smith Dir. at 23.

Thus, it appears that Verizon intends to abandon service obligations in Maine without conveying to the requisite adopting utility (in this case FairPoint), all the tools necessary to support the business. Instead, Verizon proposes to rent to FairPoint, via the TSA, features, functions and systems capable of supporting the business until FairPoint can build new systems to replace those Verizon intends to take with it when it leaves. As a concept, we, like the OPA, find that process disturbing in light of Verizon's obligations under Section 1104. OPA Br. at 62.

As we describe elsewhere in this Report, we believe that Verizon has fundamentally failed to carry its burden of proving that its proposal to abandon service in Maine is in the public interest. Part and parcel of that failure is Verizon's lack of evidence as to why support systems that have been funded by Maine's ratepayers should return *in toto* to Verizon's corporate affiliates while at the same time Verizon

[56] See also Ms. Alexander's Surrebuttal at page 2: "…the concern is highlighted by FairPoint's plan to change <u>every</u> software system currently used by Verizon to take orders, install service, monitor the network, and bill and collect for its services." [Emphasis in original]

charges the adopting utility to rent those services via additional fees. In our opinion, that construct serves simply to increase unnecessarily the costs the adopting utility will bear in replacing the services Verizon intends to abandon – costs that will ultimately be borne by ratepayers either directly through rates or indirectly through increased financial risk on the part of FairPoint. We agree with the OPA that these are risks Verizon should bear as a condition of its request for abandonment. OPA Br. at 62.

While the apparent inequity of Verizon's TSA approach is, in and of itself, problematic, our more pragmatic concern is resource-driven. As we explain elsewhere in this Report, we are concerned about the financial strength of the surviving corporation that will inherit the Maine communications infrastructure and thereafter serve Maine's communications needs. Our concern is heightened by the enormous sums of money FairPoint will pay to Verizon as a result of Verizon having chosen to centralize its operations support systems at the corporate level and its resultant inability to transfer them to the new utility upon abandonment. ADV Ex. 3.

Of further concern is Verizon's inability to substantiate that the TSA fees it intends to charge are in any way "cost based." According to Mr. Smith, while Verizon used costs allocated to Verizon Maine by Verizon's corporate operation as a starting place for calculating the TSA, the ultimate fees were "negotiated." Tr. 10/04/07 268-271. Without Verizon's ability to confirm that the fees it intends to charge are constrained in some fashion by its costs of providing the necessary services, we are concerned that the TSA may unreasonably transfer value from FairPoint to Verizon as it leaves the state behind, with ratepayers bearing the burden of the costs necessary not only to rent the old systems, but to build the new ones. In short, we believe that if

Verizon's petition to abandon its service obligations in Maine is to be found in the public interest, Verizon should be required to pass-along to the newly certified utility, a telecommunications operation that is as functional as the operation it was obligated to support prior to abandonment.

We agree with OPA that the best solution to these issues is to transfer responsibility for service delivery from FairPoint to Verizon, at least for some reasonable period of time, until new systems can be developed and tested to replace those Verizon will not transfer with the remainder of the operation. We also agree that the best way to accomplish this transfer of risk is to "reduce substantially the charges under the TSA." OPA Br. at 62. For this reason, we recommend that the Commission condition any approval of Verizon's Petition to Abandon with the following requirement: Verizon must offer its TSA services to FairPoint, in exactly the fashion agreed to by the parties via the existing TSA agreement, with one exception, i.e., Verizon must offer the agreed upon services at a price equal to $0 per month for six months, if necessary, after closing. If after six months FairPoint still requires use of the TSA services, then we believe Verizon should be allowed to begin charging fees consistent with those currently included in Schedules A-D of the TSA.[57] See Smith Dir. Ex. SES-4.

We believe the condition described above would serve two purposes. First, with the pressure of the substantial TSA payments removed, at least for the first six months, we believe that FairPoint could work more cooperatively with the Commission and the third-party monitor to ensure that all testing is completed and satisfied before FairPoint

[57] As a point of clarification, were FairPoint to still require TSA services in the seventh month after closing, FairPoint would pay to Verizon the fee contemplated in the agreement for the seventh month. Likewise, the next month FairPoint would pay fees associated with the eighth month of the agreement.

issues its Notice of Readiness and the cutover is completed. If FairPoint is ready to cutover on May 28, 2008 and all testing and monitoring indicators are satisfied, then we believe FairPoint would have the necessary incentive and should proceed to cutover on schedule. If, however, issues arise that bring a successful cutover into question, FairPoint would have the option to suspend its intended cutover for an additional two months without financial penalty. After that, FairPoint would begin to pay the required TSA fees at agreed upon rates. When combined with the five months of TSA payments it already has figured into its financial projections, the condition we recommend above would give FairPoint a total of 11 months post-closing before it begins to spend monies that are not already allocated to this purpose. We believe that timeframe should allow all parties involved the necessary time, and resources, to ensure a smooth and effective cutover.

Second, we believe that requiring Verizon to provide TSA services for a period of six months, if necessary, before being allowed to abandon its Maine operations, better balances the benefits of the Transaction in relation to Maine's ratepayers and Verizon's and FairPoint's shareholders (especially Verizon's shareholders who will become shareholders in the new utility at the close of the Transaction). It is the Maine ratepayers who have paid through their existing and historical rates to build the very Verizon systems and processes at issue. To suggest that they be able to use those systems without paying rent for an additional six months prior to losing them thereafter to the Verizon corporate umbrella for continued use on behalf of its other affiliates does not seem unreasonable. Further, we believe putting the $100 million FairPoint was to pay to Verizon to better long term use in an effort to ensure the success of the surviving utility (e.g., through more extensive broadband expansion, reduced debt-leverage, etc.), better suits all involved – ratepayers and shareholders alike.

b. Third Party Monitoring

FairPoint has offered to coordinate with, and fund, a third-party consulting firm to monitor its testing process and report back to the Maine, New Hampshire and Vermont Commissions as to the state of its systems development efforts in relation to its planned cutover readiness. FP Br. at 49; Haga/Kurtze Reb. at 38-42. No party objected to FairPoint's offer or to the specific Scope of Work represented by Advisors Exhibit 338 which would serve as the roadmap for the work of the consultant. Indeed, nearly all parties, including FairPoint, recommend that the Commission adopt this approach. FP Br. at 49.

We agree and recommend that the Commission require FairPoint, as a condition of approval, to fulfill its commitment in this regard, i.e., to fund and cooperate as necessary to allow the consultant to fulfill in a meaningful way, the Scope of Work identified in Advisors Exhibit 338. Further, we find merit in the recommendation of One that the final conclusions of the consultant be made available publicly and noticed for comment. One Br. at 24. After comment has been received, we also agree that the Commission should be able to influence FairPoint's subsequent decision to issue its Notice of Readiness and subsequently execute the cutover. While we do not necessarily agree with One that the Commission should be required to explicitly approve FairPoint's Notice of Readiness before cutover can proceed, we do agree that the Commission should reserve for itself, via a condition on any approval it may grant, the right to suspend and investigate FairPoint's readiness and suspend cutover activities based upon material defects or deficiencies identified by the consultants or in comments received by the parties. Absent such suspension and investigation, FairPoint should be allowed to manage its testing and cutover processes as currently envisioned without specific Commission approval.

c. Back office System Cost Recovery

The CLECs ask, as a general matter, that the Commission prohibit FairPoint from including in various rates (retail or wholesale) certain costs associated either with the TSA or the fees it will pay to Capgemini to develop its new systems. *See* CC Br. at 21, One Br. at 25. Likewise, they argue that if their own costs incurred in building to FairPoint's new systems are substantial, FairPoint should compensate them for those costs as well. *See* GWI Br. at 14; One Br. at 25. We believe these requests are premature. While we note that various rate-capping conditions we describe elsewhere in this Report may solve these issues for a finite period of time, in general we believe that the proper calculation of rates, both wholesale and retail, is best accomplished in light of a specific request and the facts presented therein. While we would agree that FairPoint should bear a heavy burden to prove why its customers should pay for costs to rebuild back office systems already accounted for in existing rates, we can imagine that some expenses for functionality not previously available or some other fact-specific detail might be pertinent and should be left open for debate. As such, blanket statements about proper cost recovery for these types of expenses are not ripe. We recommend that, aside from the rate-freeze recommendations we make elsewhere, the Commission should not, at this time, find that FairPoint can never recover back office system-related costs in either its wholesale or retail rates. Instead, we would recommend the Commission address such issues based upon the record-evidence presented by all parties at the time such rate changes are requested.

We believe the same approach is also reasonable in relation to CLEC requests for remuneration for costs they may incur in developing additional systems functionality necessary to interact with FairPoint's new systems. We believe such requests are best addressed based upon the facts that surround such a request. We also believe that such costs, up to a point, should be considered by the CLECs as costs of doing business. We believe it is fairly common that businesses are required to develop new systems or functionalities in order to interact with business partners and we see no fundamental differences in this circumstance – especially if FairPoint's claims that the new systems are more feature-rich and flexible are true.

However, we do see merit in CLEC concerns that the expenses they may incur could be unreasonable or excessive based upon some unique characteristic of the yet-completed FairPoint systems. As such, we would recommend that FairPoint be required to agree, as a condition of any approval of the Transaction, that the Commission may, in addressing potential complaints raised by CLECs, require FairPoint in the future to compensate those CLECs who incur unreasonable costs in moving from the Verizon to the FairPoint systems. With that in mind, we envision that only upon the specific complaint of a CLEC would the Commission address the issue, and only then based upon the facts available specific to that case (with the understanding that expenses of a relatively immaterial level would not be entertained). We would likewise recommend that the CLECs be required to prove that their expenses resulted from some unique characteristic of the FairPoint systems or from some unreasonable departure FairPoint's systems make from the Verizon systems that have already been tested via the 271 process. We believe such an approach would negate the need for speculation as to whether unreasonable costs will, or will not, be incurred. Instead, the facts specific to any given case would set the basis for future decisions of the Commission in this regard.

We find One's request that FairPoint waive all training costs related to its new systems to be an important exception to the general rule we have discussed above. We believe One's recommendation has merit and we recommend that the Commission adopt it. In other words, we would recommend that FairPoint be prohibited for a period of six months post-cutover from charging its CLEC customers for training that is specific to understanding or interacting with its new systems and interfaces. We believe such training should be an integral part of FairPoint's responsibility to provide non-discriminatory access to its operations support systems via sections 251 and 271 of the TelAct, and that charging CLECs for training on new systems when they have already spent substantial time and resources meant to support their use of Verizon's existing systems would be tantamount to double-recovery.

4. Summary of Recommendations[58]

FairPoint's back office systems will likely impact every aspect of FairPoint's business and will be key to a smooth transition if the Commission approves the Transaction. Because of choices Verizon has made to centralize its systems, ratepayers stand to lose the benefits of previously-paid for back office systems that FairPoint will be required to re-build from scratch. We believe it essential that the new systems are adequately tested prior to cutover and that all parties, including competitors, are prepared for use of the new systems. Accordingly, we recommend that the Commission consider the following conditions if it approves the Transaction:

VI-B-1	Require Verizon to offer its TSA services to FairPoint at a price equal to $0 per month for six months, if necessary, after closing. If after six months FairPoint still requires use of the TSA services, then Verizon will be allowed to begin charging fees consistent with those currently included in Schedules A-D of the TSA.
VI-B-2	Require FairPoint, as a condition of approval, to fulfill its commitment related to a third-party monitor, i.e., to fund and cooperate as necessary to allow the consultant to fulfill in a meaningful way, the Scope of Work identified in Advisors Exhibit 338.
VI-B-3	Retain the right to suspend and investigate FairPoint's readiness for cutover based upon material defects or deficiencies identified by the consultants or comments received by the parties.
VI-B-4	Require FairPoint to compensate CLECs, if a CLEC brings and successfully defends its claim, for unreasonable costs in moving from the Verizon to the FairPoint systems.
VI-B-5	Prohibit FairPoint from charging its CLEC customers for training that is specific to understanding or interacting with its new systems and interfaces for a period of six months after cutover.

[58] Elsewhere in this Report we discuss the PAP that should govern FairPoint post-closing as well as various service quality-related conditions that we think are necessary to ensure FairPoint's shareholders bear the risks related to the cutover or other potential, service-impacting problems (e.g., potential labor shortages or outside plant that is more deteriorated than expected). We likewise address in other sections FairPoint's Section 251 and 271 obligations that include non-discriminatory access to back office systems. We don't repeat those discussions here even though they may relate directly to FairPoint's back office systems and several of the parties may have discussed them in the sections of their briefs dealing with back office systems.

C. Broadband Issues

1. Adequacy of FairPoint's Broadband Expansion

a. Background

The Joint Application states that "FairPoint will increase broadband availability significantly in the three-state region within 12 months after the completion of the Merger." JA at ¶ 22, page 14. Subsequent testimony, hearings, data request responses, and public statements have provided more detail regarding FairPoint's increased broadband availability plan for Maine. According to FairPoint, within twelve to twenty-four months of closing, broadband availability in Verizon territory will increase from 70% to 83%.

i. Importance of Broadband Service in Maine

Maine's Legislature stated in 1995 that:

> The Legislature further declares and finds that computer-based information services and information networks are important economic and educational resources that should be available to all Maine citizens at affordable rates. It is the policy of the State that affordable access to those information services that require a computer and rely on the use of the telecommunications network should be made available in all communities of the State without regard to geographic location.

35-A M.R.S.A. §7101(4). Former Governor King stated in his 1999 State of the State address, "In the age of e-commerce, bandwidth is the essential commodity – just as the roads and railroads defined economic opportunity a century ago, these wires – or the lack of them – will spell the economic difference between businesses, towns, and states in the new century."

Numerous state and federal studies and reports in recent years emphasize the need for advanced communications services in the State, especially for those areas that may be economically less well off. Access to broadband services is recognized as a significant economic development tool for use by small businesses and home-based businesses, and to enable telecommuting, rural education, and telemedicine.

ii. Governor's ConnectME Initiative

In his 2005 State of the State address, Governor John E. Baldacci stated, "Tonight I am announcing 'Connect Maine' - A broad and aggressive telecommunications strategy for this State. Connect Maine will give nearly every Mainer the opportunity to plug into the global economy from their community. It will ensure that 90% of Maine communities have broadband access by 2010…" The "Connect Maine" initiative was a direct result of the conclusions and recommendations contained in the "Draft Report of the Maine Broadband Access Infrastructure Board" (11/28/05).[59] The Draft Report stated that access to broadband services is a necessity for Maine's citizens and businesses to be able to participate in the global economy, especially those areas of the more rural parts of the state.[60] The Draft Report also stated:

> Given these limitations (of obtaining accurate, granular data), a best effort estimate is that as of September 1, 2005, over 170,000 Maine residents do not have access to broadband service, which equates to nearly 75,000 households. This means that approximately 14% of Maine households do not have access to basic broadband service. This 14% is spread over the entire state, largely in sparsely populated areas. The largest census blocks with absolutely no broadband are in Jonesport, Holden, Mexico, Howland, and Paris. There are also several towns with virtually no service, such as: Appleton, Somerville, Northport, Georgetown, Orland, Penobscot, Eastbrook, Lebanon,

[59] *See* www.maine.gov/mpuc/broadband/activities/BAIB_DraftReport 110905 revised112805.pdf.

[60] The 90% level of broadband access envisioned by Governor Baldacci was assumed to be accomplished using multiple broadband delivery technologies, including DSL, cable modem, and fixed wireless.

> Industry, Weld, and Athens. As important is the information regarding households without broadband access, the information also indicates that most businesses in the same areas do not have access to affordable broadband services."

Finally, the Draft Report concludes by stating:

> The competitiveness of any state in the union depends in no small part on its ability to promote the growth of high technology business and commerce that accompanies high-speed data connectivity, a crucial component of which is universally available, secure, affordable, scalable, high-bandwidth access to the internet. Only a state that is a supremely attractive place to conduct business, to shop, and to participate in an increasingly online culture will be able to staunch the exodus of youth and brainpower that is of such concern in Maine.

The first recommendation of the Broadband Access Infrastructure Board was that the Legislature create a permanent development authority to implement the State's broadband policy. The Legislature created the ConnectME Authority in 2006 to identify unserved areas of the State, develop proposals for broadband expansion projects, demonstration projects and other initiatives, and administer the process for selecting specific broadband projects and providing funding and incentives. 35-A M.R.S.A. §§ 9201 – 9215. The Authority determined that its primary focus will be on the unserved areas of the state that have little prospect of receiving broadband service, using emerging technologies where appropriate.

iii. Verizon AFOR Stipulation

As part of a Stipulation between Verizon and the OPA in Docket No. 2005-155, Verizon agreed to spend $12 million to purchase and install the equipment and related infrastructure necessary to expand the availability of its DSL services to locations within Maine that are currently unserved or underserved for DSL service ("underserved" means that at least one other provider of broadband service is currently providing service in the same area). Twenty central offices and seventy remote terminals will be upgraded pursuant to the Stipulation. Stipulation at ¶ 1.

According to the terms of the Stipulation, any portion of the $12 million commitment that is not spent by the closing date of this Transaction, if it is approved, will be placed in escrow and specifically earmarked for FairPoint to complete Verizon's DSL commitment. Stipulation at ¶ 2. The Stipulation also states that enforcement of the commitment could be accomplished by making it an express condition of this Transaction's approval; however, it does not mention a timeline or deadline for FairPoint to finish the commitment if Verizon does not. Stipulation at ¶ 2.

b. Positions of the Parties

i. FairPoint

In the eighteen to twenty-four months after acquiring Verizon's territories in Maine, FairPoint intends to deploy advanced communications equipment that will expand the reach of its broadband products beyond the geographic footprint within which Verizon currently offers such services. Harrington, Brown, Smee Reb. at 19-21. FairPoint's $17.55 million dollar investment would be made in addition to the $12 million broadband investment that Verizon has agreed to make as a result of the recent Stipulation in Docket No. 2005-155 (i.e., AFOR proceedings). *See* Public Advocate Ex. 78; Nixon Reb. at 5; FP Br. at 55. FairPoint describes the detailed plan presented in this proceeding as a "major kick-off investment" upon which FairPoint would continue to build after the initial 24-month period for purposes of expanding broadband services to an even greater number of its Maine customers. Public Advocate Ex. 78.

FairPoint describes its current broadband plan in three phases as follows:

Phase 1:
FairPoint will install Internet Protocol/Multi- Protocol Label Switching ("IP/MPLS") equipment in 10 Maine central offices in an effort to upgrade the "core" transport network in support of Internet traffic as well as other high-speed data applications. FairPoint indicates that the upgraded core-network would support 10 gigabits of bandwidth within the IP/MPLS architecture. FairPoint projects that this phase of its broadband plan could be completed within the first four to six months after the closing. Because Phase 1 will simply upgrade the inter-office transport capabilities of the network, it will not extend broadband services to additional customers. Instead, Phase 1 will support the extension of broadband services envisioned in Phases II and III. Harington, Brown, Smee Reb. at 19-21. *See also* Public Advocate Ex. 78.

Phase II:
FairPoint will install Multi-Service Access Nodes ("MSANs") in 7 central offices which have no broadband capabilities today. The purpose of the MSAN equipment is twofold; (a) to connect customers to the upgraded access network via digital subscriber line services ("DSL") and (b) to connect these same customers to the IP/MPLS core network from central offices not housing a specific IP/MPLS router. In addition to the 7 offices that currently have no broadband facilities, FairPoint envisions that Phase II would also include placing MSAN equipment in numerous central offices wherein Verizon's Asynchronous Transfer Mode ("ATM")-based broadband platform currently provides services. The purpose for these facilities would be to support fiber-fed digital loop carrier ("DLC") locations served by these central offices, which have no broadband capabilities today but will have such capabilities after the final implementation of Phase III.[61] FairPoint indicates that it should be able to complete Phase II within 12 months of closing. FairPoint estimates that Phase II will provide broadband services to approximately 2,632 access lines that do not have access to similar Verizon products today. Harington, Brown, Smee Reb. at 19-21. *See also* Public Advocate Ex. 78.

[61] DLC equipment is generally placed in a neighborhood near individual customers and is used to connect copper extending from the customers' premises to high-capacity transmission facilities (often times fiber-optic cable) extending the remainder of the way to the central office. DSL equipment is often placed in DLC locations (also referred to as "remote terminals") in order to overcome technological limitations that exist when trying to provision the service over copper-loop facilities of a certain length (longer copper loops are, on average, poorer candidates for DSL than are short copper loops). By relying upon the fiber-optic facility extending from the central office to the remote terminal, the DSL service must overcome distance limitations related only to the copper loop that extends from the remote terminal to the customers' premises as opposed to longer copper loops that would otherwise need to extend all the way from the central office. *See* Sicker Reb. at 13-15.

> Phase III
> FairPoint will install MSAN equipment in approximately 134 fiber-fed DLC locations which serve customers who currently have no access to Verizon's broadband products. FairPoint estimates that work completed in relation to Phase III will allow it to offer broadband products to an additional 34,416 access lines. Harrington, Brown, Smee Reb. at 21.

Verizon and FairPoint estimate that as of July 13, 2007, 70% of Verizon's end-user lines in Maine were served by equipment capable of providing Verizon's broadband products. At the completion of FairPoint's three-phase broadband roll-out, FairPoint estimates that the percentage will increase to 83%. Loube Surr., Ex. RL-1. *See also* Conf. Tr. 10/2/07 at 19 where Mr. Brown confirms those percentages.

FairPoint acknowledges that the broadband technology it intends to deploy is different than the technology Verizon has pursued elsewhere, with FairPoint's platform focusing more on maximizing the use of existing copper facilities in the near term rather than the far more expensive option of extending fiber-optic facilities all the way to the "home" (i.e., Fiber-to-the-Home or "FTTH") similar to Verizon's FiOS network. Harrington, Brown, Smee Reb. at 26. In comparison, FairPoint describes its chosen technology as a platform concentrating initially on reaching customers that use dial-up services to access the Internet,[62] yet upon which more advanced technologies can be added in the future. Dr. Sicker, on behalf of FairPoint, describes FairPoint's technological choice as "a prudent migratory path toward even higher-rate data services such as Fiber to the Home..." Sicker Reb. at 2. While not a component of the 18-24 month roll-out described in testimony, FairPoint points to its other subsidiaries across

[62] FairPoint intends initially to deploy ADSL2+ and VDSL2 technology in the "last mile" component of the upgraded network, allowing for throughput equaling 25Mbps and 100Mbps respectively (depending upon the state of the underlying copper plant). Sicker Reb. at 21.

the country that use this same technological platform to provide higher-bandwidth services including IP-TV products. Harrington, Brown and Smee Reb. at 27.

In response to critics of its copper-based broadband strategy, FairPoint points to the testimony of Dr. Sicker and his projections that over time, capabilities of the copper plant will be further exploited, with potential "speeds" equaling that available from fiber-based technologies today.[63] FP Br. at 56. Further, FairPoint counters that nothing in its current plan is inconsistent with FTTH applications that FairPoint may deploy in the future and that it is not alone in pursuing an intermediate strategy focused on DSL and continued reliance on the existing copper infrastructure. FP Br. at 56. Indeed, FairPoint argues that "[a]lmost all major telephone company broadband projects in the United States use DSL and cable modem technology," including AT&T. FP Br. at 56.

FairPoint touts its broadband roll-out plan as one of the key benefits of the Transaction and a major factor the Commission should consider in finding the Transaction to be in the public interest. Leach Dir. at 6-8. Mr. Nixon, on behalf of FairPoint, indicates that the increased availability of broadband will benefit not only individual Maine consumers who are, for the first time, provided access to broadband services, but also the regional economy as a whole. Nixon Reb. at 6. Mr. Nixon describes FairPoint's commitment as a "connectivity-enabled economic development initiative … designed to work with the existing economic development agencies, providing resources, expertise and tools to assist them in establishing and meeting measurable objectives for economic growth based upon broadband connectivity and

[63] While capabilities of various broadband technologies are often referred to generically by "speed," generally referring to the overall megabits (10^6 bits) of data that can be transferred per-second ("Mbps"), "bit-rate" or "capacity" appear to be more accurate terms.

collaboration." Nixon Reb. at 6. Mr. Nixon describes this "connectivity-enabled" economic development approach as a key component of FairPoint's "department of economic development" that will be created and will report directly to him as President of the newly formed company. Nixon Reb. at 6.

In summary, FairPoint believes that its broadband plan for Maine is more aggressive than Verizon's current plans and will provide a greater number of Maine consumers with broadband products than would have otherwise had access to those products if Verizon were to remain the incumbent carrier. FairPoint believes its broadband plans constitute a major advantage to both consumers and investors.

ii. Verizon

Verizon supports FairPoint's broadband roll-out plan and opines that the additional broadband investment described by FairPoint, on top of the additional $12 million investment it will make pursuant to the Stipulation in Docket No. 2005-155, constitutes a concrete benefit to the State of Maine arising from the transaction. Verizon also argues that FairPoint's chosen technology makes sense, and that it will provide "an additional platform for additional services, including IPTV, in the future." Ver. Br. at 3. Finally, Verizon takes issue with the potential "perception" that it has failed to provide information to FairPoint sufficient to adequately inform FairPoint's broadband planning and decision making. Verizon argues that it "has made a wealth of information regarding the network available to FairPoint with access to plat and other detailed engineering records regarding central offices, remote terminates and other outside plant for purposes of assessing network status and for designing FairPoint's plans to expand the availability of DSL service in the state." Smith Reb. at 17.

iii. OPA

As a general matter, the OPA appears to support the notion that increased broadband availability would be beneficial to the public interest. However, the OPA argues that FairPoint's broadband plan does not constitute a benefit sufficient to overcome the substantial financial and operational risks arising from other components of the Transaction. Further, the OPA is concerned that the intended benefits of any broadband plan could be substantially mitigated by FairPoint's future actions unless the Commission places numerous broadband-related conditions on the Transaction; if indeed, the Commission elects to approve the Transaction at all.

The OPA's primary concerns related to FairPoint's broadband build-out can be summarized as follows:

- The broadband build-out plan as proposed by FairPoint is insufficient in size and scope to be considered of substantial benefit. The OPA argues that the Commission should require FairPoint to commit to additional investments aimed at meeting the 90% addressability objective of ConnectME and in doing so, should focus its efforts more specifically on rural areas where the broadband offerings of other providers are scant or non-existent. OPA Br. at 64-65.

- FairPoint's network build-out plan is not likely to result in a robust video service that will compete effectively with other video alternatives. Benefits resulting from increased access to, and competition for, video services should not be relied upon in offsetting other risks that might be increased by the proposed Transaction. OPA Br. at 69.

- Without pricing oversight on the part of the Commission relative to FairPoint's broadband related products, any benefits associated with increased broadband availability could be nullified by prices that do not foster accessibility. Further, because the Commission would have limited (if any) direct pricing authority over FairPoint's broadband services were the transaction to close, the OPA argues that any pricing restrictions would need to be imposed as conditions on the Transaction itself – in this proceeding. OPA Br. at 70-71.

- FairPoint's increased emphasis on broadband investment and services increases the risk that regulated services sharing the same network could be forced to subsidize broadband products that are riskier by nature. This additional risk should be offset by specific requirements that "ring fence" the regulated telephone company. One such option would be to require FairPoint to follow through on its plans to offer DSL-related services through a separate subsidiary, with the subsidiary buying services from the regulated telephone company. OPA Br. at 72-73.

- FairPoint's commitment to offer stand-alone DSL (i.e., DSL service that is not combined with FairPoint's telephone service) is inadequate for two reasons. First, the OPA argues that FairPoint's 1-year commitment to the continued provision of stand-alone DSL is not sufficient; instead, a minimum 5-year commitment is warranted. Further, the OPA argues that the price at which FairPoint would offer stand-alone DSL is also important, given that availability is of little use if no one can afford the price. OPA Br. at 76-77.

iv. Other Parties

For the most part, the remaining parties to the case either do not discuss FairPoint's broadband proposal, or focus their broadband-related comments on how the financial structure of the deal may impair FairPoint's ability to generate necessary funds or field the necessary workforce required to deliver on the broadband commitments FairPoint has made. *See e.g.,* Labor Br. at 7.

c. Recommendation

It has been acknowledged by nearly every party in the proceeding that there are risks associated with the Transaction envisioned by FairPoint and Verizon. Whether parties believe the greatest risk lies in the financial viability of FairPoint post-closing, in the execution risks inherent in the back-office rebuild, service quality or others, increased risk appears to be an undeniable reality. For the Commission's legal standard to be met, those risks must be at least offset, if not overcome, by concrete advantages that may also accrue to the State of Maine from approval of the Transaction. In our opinion, FairPoint's commitment to increase investment in facilities that will deliver broadband services to a greater number of Maine consumers is the most obvious of these potential advantages.

While there was plentiful discussion of FairPoint's broadband build-out plan in the proceeding, especially in technical workshops and at hearing, only the OPA on the side of parties provided substantial discussion of the topic in its post-hearing brief.[64] Fortunately, the OPA's analysis of the issue is thorough and well-substantiated. The OPA appears to be primarily concerned that the size and geographic scope of the build-out plan as proposed by FairPoint is insufficient to overcome the Transaction's inherent risks, thereby failing to provide satisfactory benefit necessary to meet the legal standard for approval. Nonetheless, if ultimately approved (in whatever form), the OPA also encourages the Commission to compel a number of additional requirements intended to protect the competitive marketplace generally and ratepayers specifically.

Clearly, balancing advantages accruing from increased availability of broadband services with the financial and operational risks of a smaller, more highly-leveraged provider is a process reliant heavily upon judgment. The scale tips in one direction or the other based upon the value placed on broadband accessibility and the magnitude and probability of the perceived risks. While the financial and operational risks can be quantified based upon various potential outcomes, valuing the broadband investment raises a question simpler in composition, yet equally difficult in resolution: i.e., "Is it enough?"

[64] While the CLECs described their concerns related to the going-forward availability of line sharing and wholesale DSL products, those issues are primarily concerned with competitive impacts of the transaction more so than advantages that might potentially accrue from increased broadband investment. *See* e.g.*,* One Br. at 3; GWI Br. at 11-13.

The Examiners believe that the answer to that primary question must, to the extent possible, rely upon a common understanding of the facts. Fortunately, the parties ultimately agreed to the following relevant facts:[65]

1. As of July 31, 2007, 70% of Verizon's access lines in Maine were served by equipment capable of supporting broadband services. Loube Sur., Ex. 1.

2. With the addition of $12 million in broadband related investment arising from the Stipulation signed by Verizon in Docket No. 2005-155, the percentage of broadband addressable lines is anticipated to increase to 77% by the end of 2007. Loube Sur., Ex. 1.

3. The $17.55 million FairPoint intends to invest in the detailed broadband plan included in OPA Exhibit 80 will likely increase overall addressability to approximately 83%. Loube Sur., Ex. 1.

It is worth noting that the percentages above include an underlying assumption, i.e., that the copper facilities serving these various Maine customers are "qualified" to support the necessary broadband signals. Early on in the proceeding it was reported that Verizon's broadband services were currently available to only 62% of its access lines, whereas FairPoint's additional investment would increase availability to over 80%. Leach Dir. at 8. However, after further investigation Dr. Loube determined that these two values were not a good comparison. Indeed, after categorizing the data to provide a more meaningful relationship, Dr. Loube determined that using FairPoint's definition of availability, Verizon's current penetration was actually about 70% - thereby making the resultant increase much less dramatic. Loube Sur. at 3 and Ex. RL-1. The difference results from the fact that FairPoint and Verizon were measuring different things when

[65] *See* Tr. 10/02/07, Conf. Level 1 at 19 where Mr. Brown, on behalf of FairPoint, agrees that the information in Loube Surrebuttal Exhibit RL-1 is information that FairPoint, Verizon and the Public Advocate collaborated on in order to derive a common, agreed-upon set of data.

comparing relative percentages. FairPoint initially measured the total number of access lines served by equipment that would be upgraded to support DSL services – what has been referred to as "addressability" in this proceeding. Verizon, on the other hand, was counting only those lines that were both (a) addressable (i.e., served by similar DSL-capable equipment), but also (b) had copper loop characteristics that would support DSL services (i.e., loops of an acceptable length[66] and free of load coils and/or other disturbers) – what is described as a "qualified" access line. Loube Sur. at 3.

With that distinction in mind, the following chart details the percentage increase in both "addressable" and "qualified" lines that would most likely be added with the advent of both Verizon's $12 million as well as FairPoint's $17.55 million investments. *See* Loube Sur., Ex. 1.

All Maine Wire Centers		
Scenarios	Addressable Lines	Qualified Lines
Current 07/31/2007 Lines	70%	62%
Verizon AFOR stipulation	77%	68%
Fairpoint DSL Plan	83%	74%

It is important to note that Mr. Brown has argued on the part of FairPoint that many access lines not "qualified" to provide DSL services today can be manipulated to achieve qualified status through the removal of existing load coils and/or bridge taps as well as the use of newer "smart coil" technology and other means. Harrington, Brown and Smee Reb. at 24. In his opinion, the disparity between the two different measurements is not as great as it might appear. We find merit in Mr. Brown's discussion in this regard and believe that the number of "qualified" lines could certainly

[66] Mr. Brown notes that Verizon, in developing its estimates, considered a copper loop to be "qualified" only after having confirmed through the use of a metallic loop test that the loop was 18,000 feet in length or shorter. Harrington, Brown, Smee Reb. at 24.

be increased with these activities, thereby closing the gap between "qualified" and "addressable" lines. However, we also note that at least some of the expenses associated with these types of activities are not specifically included in FairPoint's $17.55 million broadband budget and, as a result, we believe that maintaining the distinction included in the table above is important in ensuring that any analysis of broadband service growth afforded by FairPoint's investment is accomplished on an "apples to apples" basis.[67] Given the importance of comparing "apples to apples," our discussion here-forward will refer to the "addressable line" information above and will, for purposes of consistency, make comparisons only between data in that column.

Percentages aside, FairPoint estimates that its proposed plan will offer broadband services to more than 37,000 Maine consumers who would not otherwise have similar access from Verizon, even after Verizon has undertaken the additional investment envisioned by the AFOR stipulation.[68] Harrington, Brown and Smee Reb. at 20-21. Similarly, its investment in a newer, more flexible IP/MPLS backbone will increase interoffice broadband transport functionality and pave the way for additional services in the future. Finally, though not a component of its detailed broadband plan identified in OPA Exhibit 80, FairPoint has also indicated its intention to "meet the goals of the Governor's ConnectME broadband initiative by the year 2010." Harrington Dir. at 3. These achievements would, without doubt, benefit the State of Maine and Verizon's

[67] See Tr. 10/02/07 at 57-59. Note that while Mr. Brown explains that the $17.55 million figure includes $1 million for "outside plant enhancements," he indicates that some portion of that budget must go to fiber splicing activities. He likewise describes the fact that conditioning activities like removing load coils would generally be expensed, and hence, would not be part of the capital budget.

[68] Mr. Brown explains that Phase II will add approximately 2,632 access lines while Phase III will increase broadband addressability by 34,416 access lines, totaling 37,048 additional access lines. Harrington, Brown and Smee Reb. at 20-21.

existing customers. However, true to our question above, we must still determine: "Is it enough?"

Dr. Loube on behalf of the OPA concludes that FairPoint's proposed expansion is definitely not enough. He argues that FairPoint should, by 2010, be required to invest in equipment capable of ensuring that 90% of the access lines it would acquire from Verizon in Maine are DSL addressable. Loube Sur. at 1. According to Dr. Loube, this level of addressability would require an additional investment as high as $79.6 million beyond that already contemplated by FairPoint. Loube Sur., Ex. RL-3. According to Dr. Loube, this increased investment would not only allow FairPoint to single-handedly achieve within its service territory the overall 90% addressability contemplated by the Governor's ConnectME initiative, but would also dramatically increase addressability in more rural areas when compared to FairPoint's existing plan.[69] Loube Sur., Ex. RL-2.

As a general matter, we agree that there are distinct and meaningful advantages to increased broadband availability within Maine. We agree with FairPoint that increased availability would not only enhance the quality of life for those individuals who would for the first time have access to high-speed services, but should also benefit economic development activities throughout the acquired service territory. Nixon Reb. at 6. Further, we believe FairPoint has succeeded in explaining that the technology choices it is making are, as an intermediate step, reasonable. While most people would undoubtedly prefer the incredible bandwidth available from a FTTH alternative, economics must play a role in determining how finite investments can be used to provide the most meaningful overall impact. We believe that FairPoint's technological

[69] For purposes of his analysis, Dr. Loube defines rural wire centers as those for which UNE Zone 3 prices apply.

architecture reasonably balances the various service-delivery alternatives with the economics of the marketplace at this time.

Also, unlike some parties, we are not concerned that the details of FairPoint's broadband expansion plan evolved throughout the proceeding. An undertaking of this type involving detailed engineering expertise is likely to evolve until completed. We believe that FairPoint's proposed broadband expansion could go a long way to offsetting many of the financial and operational risks we discuss elsewhere in this Report. However we, like the OPA, note that FairPoint's highly touted expansion plan would increase addressability by only 6% after considering the investments required of Verizon prior to closing. Further, given that much of this investment will equip lines in urban and suburban areas of the State, it is likely that some portion of that 6% increase will increase FairPoint's addressability to customers who already have other broadband alternatives, and would not represent a net increase in overall broadband addressability in Maine. Hence, in answering the central question of "Is it enough," we recommend that the Commission answer "No."

As explained elsewhere in this Report, the financial and operational risks associated with this Transaction are numerous and real. Advantages meant to offset those risks must be equally numerous and real. A broadband plan that increases addressability by a maximum of 6% does not fit the bill, even when combined with other potential advantages (*e.g.,* state-of-the-art back office systems). We agree with the OPA that additional investment is needed in more rural exchanges and that the overall level of addressability must be higher if the plan is to successfully offset the concurrent risks of the Transaction. We are not convinced, however, that the overall objective should be to place the goals of the ConnectME initiative, and its 90% penetration goal, solely on the shoulders of FairPoint. We believe ultimately that partnerships between public and private enterprises as well as innovative technologies (e.g., wireless) will be necessary to expand the availability of broadband services toward, or in excess of, 90% in the most economically rationale way. We also are convinced by FairPoint that it will endeavor more earnestly in this pursuit on behalf of Maine's citizens than Verizon has to date – thereby, in and of itself, offering an advantage to the Transaction.

As a general matter, we are not convinced that pursuit of a generalized addressability percentage is the most advantageous objective in a proceeding such as this where more detailed investment information and wire-center specific details are available. We believe the granularity of data in this proceeding provides the Commission the ability to focus resources more specifically toward meeting what we believe is the most important objective – i.e., increasing broadband availability for those citizens who currently have no other alternative. Toward that end, we note that Dr. Loube estimated his 90% addressability recommendation could be achieved with additional investment on the part of FairPoint ranging between approximately $7.20 million on the low end to $76.96 million on the high end. Loube Sur. at RL-3. From our perspective, adopting Dr. Loube's recommendation, when the underlying investment required to achieve it lies within such a broad range, is not reasonable.[70] What we recommend instead, is that the Commission require FairPoint to increase the

[70] In addition to the data provided by Dr. Loube, Mr. Brown estimated that FairPoint would need to invest an additional $30- $40 million to achieve 90% addressability, noting that these figures were "very broad gauge" and that those additional investments would likely support IPTV equipment in those areas as well. Pub. Tr. 10/02/07 at 81-82.

investment currently committed to its broadband expansion plan from $17.55 million to $28 million. This increase corresponds roughly to the additional investment envisioned by Dr. Loube necessary to approach his 90% penetration level under generous circumstances. Loube Sur., Ex. RL-3, middle column entitled "average feeder distance." Further, we recommend that the Commission require FairPoint to focus this additional investment ($10.45 million) in rural areas, preferably unserved by other broadband delivery technologies. For purposes of this requirement, we believe Dr. Loube's identification of wire centers currently priced as UNE Zone 3 for unbundled loops is a good proxy. Within those particular wire centers, we believe FairPoint should have the latitude to employ the additional investment at its discretion, with the goal of offering broadband services to as many customers as possible being the overarching goal.

We believe the additional investment we have recommended above is required to ensure that Maine's citizens receive benefits in relation to this Transaction, commensurate with risks they will also bear. However, we are concerned that requiring FairPoint to invest its proposed $17.55 million, plus the additional $10.45 million we are recommending here, on top of compensating Verizon for the $12 million Verizon agreed to invest in the Stipulation in Docket No. 2005-155 places too much of the responsibility for broadband expansion on FairPoint, and not enough on Verizon as the incumbent who requests the Commission's approval to abandon its obligations in Maine. It is a simple fact that had Verizon been more aggressive in the past few years in upgrading its Maine network to support data-centric services, as it has done in many of its other markets, that the "catch-up" activities now being transferred to FairPoint upon Verizon's abandonment would not be as extensive or as costly. Tr. 10/04/07 at 53-55.

Likewise, as we have described in detail in the portion of this Report dealing with the financial implications of the Transaction, we believe that FairPoint's cash-flow in the first few years is a critical factor in bolstering its chances for long-term success. As such, we would recommend that the Commission require Verizon, as a condition of its request for abandonment, to pay the entirety of the $12 million in additional broadband investment it agreed to make in Docket No. 2005-155, without seeking, or receiving, reimbursement, either directly or indirectly, from FairPoint. Further, as a precaution, we would recommend that the Commission condition any approval of the Transaction on forbidding FairPoint from compensating Verizon, either directly or indirectly, for those same investments.

2. Video Availability

We now must turn our attention to other broadband-related concerns voiced by the parties, primarily the OPA. First is the OPA's concern that FairPoint may not be able to field a video product that competes successfully with alternative providers like the incumbent cable companies. From our perspective, this is an issue more readily addressed in the section of this Report dealing with FairPoint's financial projections. While an additional video supplier would undoubtedly be a good addition to the marketplace and would surely drive benefits to end user customers, increasing competition in the video market appears to us to be far afield of our objectives in this proceeding. Nonetheless, to the extent that FairPoint's competitiveness in wireline telephony and broadband services is hamstrung by what may be perceived as a weak video offering, such a circumstance should be viewed in light of FairPoint's forecasted financials. We consider those types of issues elsewhere in this Report.

3. DSL Pricing

The OPA asks the Commission to impose a number of pricing restrictions on FairPoint related to its various broadband products. As an example, the OPA recommends that FairPoint be required to adopt Verizon's $15 per month rate associated with 768 Kbps service - a price the OPA describes as "for life." OPA Br. at 5. Jurisdiction regarding DSL is an issue already visited by the FCC and the courts,[71] resulting in a limited ability on the part of states to affect pricing. While including conditions relating to DSL pricing may be allowed under the broad auspices of 35-A M.R.S.A. § 708, any such conditions should be limited and focused. Accordingly, we find the OPA's proposed conditions are too broad and recommend that the Commission not adopt them.

We recognize the fact that true accessibility to broadband products includes not only the technological access to facilities that can support such services, but also prices that consumers can afford. However, we believe, where possible, that the competitive marketplace is better positioned to govern prices for these types of services. Hence, we recommend that the Commission place a single condition on FairPoint related to broadband pricing generally:

> FairPoint must price its broadband-related services at statewide rates, without differences between urban, suburban or rural wire centers. Specifically, we believe that all promotional and standard offerings should

[71] *Appropriate Framework for Broadband Access to the Internet over Wireline Facilities*, Report and Order and Notice of Proposed Rulemaking, 20 FCC Rcd 14853 (2005).

be available to all of FairPoint's Maine-based customers at the same prices, terms and conditions.

It is our hope that with this condition in place, the competitiveness of the broadband market in areas where plentiful alternatives exist will discipline FairPoint's offerings in areas where it may be able to exert more direct market power, while at the same time providing FairPoint the pricing flexibility it needs to compete effectively.

4. Cross-Subsidization

The OPA raises concerns that FairPoint may subsidize its broadband business using revenues from, or shifting costs to, the regulated utility. To combat this, the OPA recommends that FairPoint be subjected, as a condition of this merger, to the "ring-fencing" requirements of Chapter 820, i.e., limitations regarding a utility's use of regulated revenues and assets for its affiliate operations. Currently, Chapter 820 does not apply to telecommunications providers because the FCC's accounting and separations rules already cover these issues. OPA Br. at 72.

Further, the OPA recommends that FairPoint be explicitly required by the Commission to follow through on its current plan to offer DSL-related services via a subsidiary separate and apart from the regulated telephone company. The unregulated subsidiary, according to the OPA, would then pay to the regulated company a monthly fee associated with the functionalities necessary to support the DSL-related products the unregulated subsidiary buys from the utility to serve its retail customers. As a starting point, the OPA recommends that the unregulated subsidiary pay to the telephone company a rate equal to **BEGIN SUPER COMPETITIVELY CONFIDENTIAL** _____**END SUPER COMPETITIVELY CONFIDENTIAL** per month, per DSL service (regardless of bit-rate), the amount currently used within FairPoint's financial model. OPA Br. at 73, citing Loube Sur., Ex. RL-10 and ODR-16.

DSL-related services are provided by shared facilities that support not only DSL, but at the same time regulated, voice and time-division multiplexed ("TDM") data services.[72] Physically separating the network between regulated versus non-regulated activities is impractical. For this reason, accounting tools are generally used instead, with limited success, to separate regulated versus non-regulated costs and revenues. OPA Br. at 73-74. The structural mechanism recommended by the OPA via the use of a separate subsidiary, is an additional tool that could be used to protect against cross-subsidization. And while we do not believe that the broader proposal to subject FairPoint to the overarching ring-fence requirements of Chapter 820 are necessary, we do find merit in the idea of formalizing FairPoint's plan to use a separate broadband subsidiary and recommend that, if it approves the Transaction, the Commission consider the imposition of a condition requiring FairPoint to maintain such a non-regulated subsidiary.

Specifically, under our proposed condition, the non-regulated subsidiary would purchase DSL-related functionality from the utility and thereafter sell DSL services to its retail customers. We believe this is the most efficient means by which to ensure that costs and revenues associated with DSL are allocated in proportion between the regulated and unregulated businesses. We also believe it would negate the need for the accounting-based protections described by the OPA at pages 73-75 of its Brief.

[72] TDM services are often referred to as "circuit switched" services and are differentiated from packet-switched technologies such as IP services.

Further, we agree that allowing the Commission to approve the "transfer rate" at which the unregulated subsidiary will purchase DSL functionality is reasonable and helpful in preventing cross-subsidization. For these reasons, we believe the following condition has merit, and would go a long way toward reducing risks of cross-subsidization that will be increased with FairPoint's increased reliance on broadband services as it transitions toward a more data-centric company:

> For a period of at least three years from closing, FairPoint will provide all DSL-related services from a subsidiary separate and apart from the regulated telephone enterprise. The separate subsidiary will purchase all DSL-related functionalities from the regulated utility at a rate equal to **BEGIN SUPER COMPETIVIELY CONFIDENTIAL** _____ **END SUPER COMPETITIVELY CONFIDENTIAL** per line, per month. To the extent that FairPoint, at any time during this period, believes that the "transfer rate" identified above should be adjusted, based upon changes in cost incurred by the regulated enterprise in providing the necessary functionality, FairPoint may petition the Commission to review the rate and if necessary, approve a different rate. The Commission may, at its discretion, extend the period within which FairPoint is required to maintain this arrangement for one additional 3-year period.

We choose an initial transfer rate of **BEGIN SUPER COMPETIVIELY CONFIDENTIAL** _____ **END SUPER COMPETITIVELY CONFIDENTIAL** for the same reason the OPA chose it, i.e., FairPoint uses that value itself within its financial model as an "elimination" intended to reconcile revenues earned by the utility but also identified as costs to its subsidiary in support of its line sharing product. OPA Ex. 8, Tab: *Detail*, Cells: F272-P272. FairPoint's reliance on that value in developing its financial forecasts, leads us to believe that it is a good indication of what FairPoint believes such services will cost. However, to the extent FairPoint believes that value is a poor representation of its costs, our proposed condition above provides it the flexibility to present its cost information in support of a different rate.

5. Stand Alone DSL

Finally, the OPA argues that FairPoint's commitment to provide "stand alone DSL" for a 1-year period is inadequate, and should be increased to 5 years. OPA Br. at 77-78. Further, the OPA argues again that availability, without some constraint on the price meant to ensure affordability, is meaningless. OPA Br. at 78. We agree in concept though perhaps not in execution.

We find the OPA's discussion at page 76 of its Brief compelling with regard to the increase in price Verizon instituted with its stand alone DSL service, increasing the rate from an initial level of $20 per month immediately following its merger with MCI, to its current rate of $47.99 for a month-to-month customer. We also share the OPA's concerns about the harm that could result from tying unregulated DSL services to regulated telephone services, when no alternative exists to purchase DSL on a stand-alone basis. OPA Br. at 76. While we believe strongly that bundled products at reduced rates have economic and marketing merit, in this instance, when one of those products is a price-regulated product and the other is not, competitive advantages inherent in the provision of the regulated service can be transferred too easily to the market for the non-regulated service. Giving consumers an option to purchase DSL on a stand alone basis at a price reflective of the underlying costs of providing the service, regardless of who they choose for telephone service, would help to alleviate those concerns. Accordingly, we recommend the Commission consider the following condition:

> For a period of at least three years from closing, FairPoint will provide, where it has the facilities to do so, its DSL products on a stand alone basis. Specifically, FairPoint will not include requirements that consumers also purchase its telecommunications services or any other services it

> offers as a condition of purchasing DSL services. During this period, FairPoint's stand-alone DSL service will not exceed the effective transfer price described above, plus 25%. The Commission may, at its discretion, extend the period within which FairPoint is required to maintain this arrangement for one additional 3-year period.

We believe that using the transfer price described above as the baseline for FairPoint's stand alone DSL accomplishes two important tasks. First, it provides FairPoint with competing incentives in relation to establishing the necessary transfer price. Tying its stand-alone DSL rate to the transfer price creates an incentive that should encourage FairPoint not to pursue a transfer price that is too low, otherwise it runs the risk of its stand alone DSL price eroding demand for its bundled DSL products. This type of incentive should serve to counteract an inherent incentive FairPoint might otherwise have to establish a very low transfer price, thereby transferring as little of the cost, and as much of the revenue as possible for its DSL services from the regulated entity to the non-regulated affiliate. These off-setting incentives should ensure that FairPoint strives toward a transfer price that truly corresponds to its actual costs of providing the DSL services. Second, using the transfer price as the baseline for FairPoint's stand alone DSL product leaves the pricing decision, ultimately, to FairPoint who must balance the counteracting incentives discussed above before asking the Commission to approve a given rate. FairPoint should understand its underlying cost structure better than any other party and thus leaving it in control of its pricing decisions, within the confines of the minimal conditions described above, should benefit the marketplace as a whole.

We have included an additional 25% on top of the transfer price in recognition that there are likely to be marketing and other non-telecommunications related costs that accrue to the unregulated subsidiary and which are not accounted for in the transfer price. We have chosen 25% because it roughly matches the avoided wholesale discount currently approved by the Commission for Verizon when it resells services to competing carriers *New England Tel.& Tel. and AT&T Comm. of NE, Request for Arbitration*, Docket No. 96-510, Order (Jan. 30, 1997).[73] Conceptually, the avoided cost discount used for resale customers is intended to account for marketing and other retailing costs that exist on top of direct costs associated with producing the service in question. Accordingly, we believe using the wholesale discount in this instance, to capture FairPoint's marketing and retailing costs for its stand alone DSL service, is a reasonable proxy.

6. Summary of Recommended Conditions

The Examiners recommend that the Commission find that FairPoint's Broadband Plan, as filed, is not sufficient to offset the financial and other risks associated with this Transaction. If the Commission ultimately approves the Transaction, we recommend the Commission consider imposing the following conditions to improve the viability of FairPoint's Broadband Plan:

[73] The Commission approved four different resale discount values in Docket No. 96-510, ranging from 19.8% to 25.74% depending upon whether the discount is being applied to a residential or a business service, and the extent to which the competing carrier was purchasing operator services from the incumbent, or not.

VI-C-1	Require FairPoint to increase the investment currently committed to its broadband expansion plan, from $17.55 million to $28 million.
VI-C-2	Require FairPoint to focus the additional investment ($10.45 million) in rural areas, preferably unserved by other broadband delivery technologies.
VI-C-3	Require Verizon, as a condition of its request for abandonment, to pay the entirety of the $12 million in additional broadband investment it agreed to make in Docket No. 2005-155, without seeking, or receiving, reimbursement, either directly or indirectly, from FairPoint.
VI-C-4	Forbid FairPoint from compensating Verizon, either directly or indirectly, for the $12 million in DSL investments related to Docket No. 2005-155.
VI-C-3	Require FairPoint to price its broadband-related services at statewide rates, without differences between urban, suburban or rural wire centers. All promotional and standard offerings should be available to all of FairPoint's Maine-based customers at the same prices, terms and conditions.
VI-C-4	For a period of at least three years from closing, FairPoint will provide all DSL-related services from a subsidiary separate and apart from the regulated telephone enterprise. The separate subsidiary will purchase all DSL-related functionalities from the regulated utility at a rate equal to ****BEGIN SUPER COMPETIVIELY CONFIDENTIAL** _____ **END SUPER COMPETITIVELY CONFIDENTIAL**** per line, per month. To the extent that FairPoint, at any time during this period, believes that the "transfer rate" identified above should be adjusted, based upon changes in cost incurred by the regulated enterprise in providing the necessary functionality, FairPoint may petition the Commission to review the rate and if necessary, approve a different rate. The Commission may, at its discretion, extend the period within which FairPoint is required to maintain this arrangement for one additional 3-year period.
VI-C-5	For a period of at least three years from closing, FairPoint will provide, where it has the facilities to do so, its DSL products on a stand-alone basis. Specifically, FairPoint will not include requirements that consumers also purchase its telecommunications services or any other services it offers as a condition of purchasing DSL services. During this period, FairPoint's stand alone DSL service will not exceed the effective transfer price described above, plus 25%. The Commission may, at its discretion, extend the period within which FairPoint is required to maintain this arrangement for one additional 3-year period.

VII. SERVICE QUALITY

A. Introduction

To approve the Transaction, the Commission must find that the ability of the utility to provide safe, reasonable, and adequate service is not impaired. 35-A M.R.S.A. § 708(2)(A)(4). Thus, the Transaction should not be approved if the evidence supports a finding that FairPoint will not be able to maintain reasonable and adequate levels of service quality and there are no conditions that could be imposed to address these. This is a difficult determination to make because virtually all aspects of this Transaction could impact service quality. However, to allow a productive discussion and evaluation of the Transaction with regards to service quality, we recommend that the Commission use two overriding principles in its evaluation of the Transaction from a service quality perspective.

First, the Applicants should demonstrate that service quality will not deteriorate if the Transaction is approved. Second, existing unreasonable or inadequate service quality should be improved to reasonable and adequate levels as a condition of approval and/or abandonment. The first principle is clearly required by 35-A MRSA § 708(2)(A)(4), i.e., the ability of the utility to provide safe, reasonable, and adequate service is not impaired by the Transaction. The second principle is based upon 35-A M.R.S.A. § 1104, which allows the Commission to impose on Verizon "such terms, conditions or requirements as in its judgment are necessary to protect the public interest."

B. Summary of Parties' Positions

1. FairPoint's Overall Service Quality Commitment

FairPoint has committed to "provide service that is comparable or better than that currently provided." Nixon Dir. at 24. FairPoint further states that it "will implement processes and systems that will enable employees to provide high levels of service. The systems will be state-of-the-art and integrated in a fashion that will facilitate productivity and give employees the tools to provide high levels of customer service and satisfaction." *Id*. FairPoint also commits (for retail customers) to "adopt or concur in the terms, conditions and process of Verizon's tariffs as of the closing which will make the transaction transparent to Verizon's existing customers…No existing retail service will be discontinued or interrupted as a result of the proposed transaction." Nixon Dir. at 26. Finally, FairPoint states that it will adopt the existing service quality performance standards that apply to Verizon as its goals, and acknowledges that it will be subject to the penalty provisions that currently apply to Verizon, i.e., the existing AFOR Service Quality Index (SQI). Nixon Reb. at 34.

To meet its commitment, FairPoint claims it will organize its corporate structure to be "customer facing," will hire 675 additional staff to work in the three state region, purchase new back office systems to perform customer services and billing functions, and propose a plan to improve the "residential trouble reports not cleared in 24 hours"[74]

[74] This is a metric contained in the current AFOR SQI that measures the percentage of residential repair appointments that are not cleared in 24 hours.

and the "network trouble report rate"[75] performance for Verizon. Each of these areas is discussed in further detail below.

2. OPA

The OPA's recommendations reflect two overriding objectives. First, the OPA contends that the Commission should transfer the risk of potential deterioration in customer service and service quality from customers and ratepayers to the shareholders and the owners of FairPoint. Alexander Dir. at 30. The "risk" OPA references is associated with the cutover process, pressures to achieve desired operating efficiencies at the expense of service quality, labor issues, and FairPoint's focus on unregulated services rather than traditional voice service. OPA Br. 54 – 62. The OPA further asserts that unless these risks are mitigated, they may result in service quality performance by FairPoint that will be worse than that of Verizon. OPA Br. at 63. Second, the OPA argues that the Commission should not simply rely on FairPoint's vague and unsupported promises to assure adequate service quality. Alexander Dir. at. 30. If the proposed Transaction is approved, the OPA believes the Commission should establish concrete and enforceable service-quality measurements and delineate specific consequences for any failure by FairPoint to provide improved service quality. *Id.*

3. Labor

Labor argues that service quality for Maine's landline customers today is below acceptable levels and that if the Transaction in approved, service quality will be put at additional risk. Labor Br. at 23. Labor also contends that FairPoint's ability to achieve acceptable levels of service quality will be impaired by a lack of adequate resources, the

[75] This is a metric contained in the AFOR SQI that measures the number of trouble reports filed per 100 lines.

potential loss of experienced workers, and the significant risks posed by FairPoint's creation and implementation of dozens of new operational, support, and administrative functions. *Id.* Labor concludes that 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. *Id.* Based on this, as well as FairPoint's history of mediocre service, Labor asserts that the Commission must conclude that FairPoint will not be able to provide adequate and reliable service to Maine consumers and therefore should reject the Transaction. *Id.*

Labor states that if the Commission believes that FairPoint's severe financial deficiencies can be overcome, then in the alternative, the Commission should consider approving the Transaction only with stringent conditions to ensure that service quality is improved and backed up by financial consequences sufficient to avert a "pay to play" response from FairPoint management. Labor Br. at 38. Labor also recommends conditions to address FairPoint's lack of planning for possible workforce depletion. *Id.*

C. Management Structure

1. Positions of the Parties

a. FairPoint

FairPoint states that its guiding principle is to create an organization that is customer-facing with senior-level decision makers located within the three states. Nixon Reb. at 12. The regional team will be accountable for the operational performance, financial results and customer satisfaction within Northern New England and, as such, will be given the appropriate levels of authority to meet their commitments. To the extent possible, decisions will be made locally, taking into consideration the needs of customers, employees, and the Maine, New Hampshire and Vermont operations. Customers and regulators in the State of Maine, as well as in the States of New Hampshire and Vermont, will be able to interact directly with FairPoint's regional executive team. Nixon Reb. at 15.

FairPoint also states that it recognizes that in a competitive environment, customers will make decisions regarding the carrier they want based on the value of the services that the carrier provides, e.g., price, quality of service, timeliness of installation and repair, and services that meet their needs, and that this concept is the rationale behind a customer-facing organization. *Id*. FairPoint's vice presidents for wholesale, business and consumer markets will be accountable for those customer relationships in terms of service quality, revenues and direct expenses for that line of business across all three states. Within FairPoint, those individuals will have meaningful budgetary authority and profit and loss accountability. Each of those individuals will live in one of the three states of Maine, New Hampshire or Vermont. *Id*.

FairPoint claims that in addition to any service quality objectives mandated by the Commission, FairPoint will establish Key Performance Indices (KPIs) by functional area of responsibility that will be used as management tools to operate the business. The KPI's will include goals and objectives that will be consistent with FairPoint overall objectives for service quality (including service quality objectives established by the Commission), employee development, revenues, direct expense and operational improvement and safety, which in turn will be tied to FairPoint's compensation system. ADV Ex. 197. The KPIs associated with service quality will include Troubles Not Cleared Within 24 Hours, Mean Time to Repair, Installation Trouble Report, Repeat

Trouble Rate, Due Date Performance, Speed of Answer in Call Centers (customer service, repair, operator and directory assistance), Abandon Rate in Call Centers, and Responses to Customer Surveys. Nixon Reb. at 23 - 24.

b. Labor

Labor argues that FairPoint's past poor performance on service quality does not provide a basis for concluding that FairPoint has a corporate commitment to high quality service. Labor Br. at 23. Labor contends that FairPoint's existing Maine subsidiaries have not demonstrated a commitment to providing consistently high service quality. Labor Br. at 31. Labor claims that FairPoint subsidiaries have experienced a relatively high level of customer complaints, billing problems, and trouble report rates and have among the highest customer trouble report rates in Maine.[76] *Id.* In light of this past poor performance, Labor believes that there is no evidence to indicate that FairPoint would be able to meet its commitment to improve on Verizon's service. *Id.*

2. Recommendation

FairPoint has hired experienced senior level managers who appear to have the ability, as well as the desire, to provide good service quality. We believe the proposed management structure reflects this commitment. Labor's arguments concerning past service quality problems within the FairPoint subsidiaries operating in Maine, while relevant, does not take into account that the new management team and structure did

[76] Labor points out that China Telephone had the worst customer trouble report rate in 2005, 2006 and the first quarter of 2007 of the 23 companies reporting to the Commission; Northland had the sixth worst customer trouble report rate in the first quarter of 2007, the seventh worst in 2006 and the eighth worst in 2005; China Telephone had the worst customer complaint rate in Maine from 2004 through 2006 – underperforming the other 22 incumbent telephone companies - and in 2005 and 2006; and FairPoint subsidiaries accounted for the three worst customer complaint rates in the state. Peres Dir. at 9 – 10.

not exist during the periods of alleged poor performance cited by Labor. We therefore recommend that the Commission find that FairPoint is committed to providing good quality service to its customers and appears to have taken appropriate steps with regard to its management structure to make this happen.

D. Human Resources

1. Positions of the Parties

a. FairPoint

FairPoint states that it views the experienced Verizon workforce as the "cornerstone" of its organization moving forward and that a skilled workforce will be essential to meet its objectives. Nixon Dir. at 17. FairPoint also states that, based on information from Verizon, approximately 2,700 to 2,800 Verizon employees will continue their employment after the close. These employees include managers, regulatory staff, installation and repair technicians, central office technicians, splice-service technicians, engineers, customer sales and service representatives and others. FairPoint claims that it tracks the status of Verizon employees via an employee identification number, job classification, and associated years of service, on a monthly basis and that it is able to track any significant variance in employees by work function and/or years of service. Nixon Reb. at 16. Finally, FairPoint points out that Verizon is contractually required to run the business in the "normal course" and as such must staff the Maine, New Hampshire and Vermont operations accordingly. *Id.*

FairPoint also states that it will add over 675 positions in Northern New England to replace work functions that are performed by Verizon outside of that area, to improve service quality, and to increase its focus on the residential and business customers.

OPA Ex. 53. Of these positions, at least 280 additional jobs will be added to Maine, primarily in the Portland and Bangor areas. The functions for the positions in Bangor will include outbound telemarketing, accounting, billing support, field marketing, and an internal IT helpdesk. The positions in Portland will include business and wholesale sales, accounting, legal, human resources, bill production, billing analyst, supply chain, staff services support, and an IT desktop support. FairPoint claims that moving these back office functions into the three state region should provide improved levels of customer service. *Id*.

FairPoint also points out that it hired a number of its Maine, New Hampshire and Vermont-based executives early in this process to help design the organization and business processes, thereby enabling FairPoint to "run the business" during and after the TSA period. Nixon Reb. at 28. Further, pursuant to its contract with Capgemini, Capgemini must provide the necessary assistance, including staffing, through the final release, currently scheduled for six months following cutover. *Id.* FairPoint claims that this will provide more than ample support while FairPoint hires personnel to meet these needs on a going-forward basis. *Id*.

b. Labor

Labor argues that if the proposed Transaction is approved, Northern New England risks a mass exodus of experienced Verizon workers and, if large numbers of workers leave, FairPoint will be hard pressed to find and train the needed replacements in a timely fashion. Labor Br. at 27. Labor further points out that even if FairPoint could hire enough new workers to fill the slots of those who leave, there will still be major problems due to the loss of experience. *Id*. Labor bases this conclusion on a survey it conducted in August of 2007 of Verizon employees who would transfer to FairPoint if the merger were approved.[77]

Results of the survey showed that 49% of all the employees returning the survey stated that they would seriously consider leaving if the Transaction were approved. Labor Br. at 28 - 29. Extending these survey results to the entire union-represented workforce in the three states, Labor contends that more than 1,200 workers currently employed by Verizon across the region are seriously considering leaving if the Transaction is approved. *Id.* Further, Labor claims that 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. The survey results show that 68% of the pension-eligible workers are seriously considering leaving their current employment solely because of the Transaction. Labor Br. at 29. Labor concludes that the results of the survey present a grave picture for FairPoint and its customers if the Transaction is approved. *Id.*

Labor also argues that the high number of respondents who indicate they will consider leaving indicates a strong possibility that many experienced workers will leave if the Transaction is approved. Labor claims it takes 42 months for a new Verizon technician to be considered fully trained and able to work independently, therefore, FairPoint could face an immediate jobs crisis due to the loss of pension-eligible workers alone. Labor Br. at 30. Labor further states that as positions go unfilled, or are filled

[77] Over 1000 completed surveys were collected, accounting for more than 40% of the union-represented workforce. 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. Labor Br. at 28 - 29.

with inexperienced workers, the remaining workforce also will see degradation in their work experience, which is likely to make improving service quality more difficult. Labor argues FairPoint has not provided any indication that it is concerned with these issues and has failed to develop contingency plans to deal with the possibility that significant numbers of workers will leave if the Transaction is approved, thereby compounding the seriousness of the problem. *Id.* To address this potential loss of experienced workers, Labor recommends that the Commission require FairPoint to develop a detailed plan that identifies the number, job title and location of likely job losses and provide a process for backfilling positions and training replacements. *Id.* at 38.

2. Recommendation

We are concerned that if the Commission approves the Transaction, FairPoint may lose a significant number of experienced employees that it will have a difficult time replacing, causing a detrimental impact on service quality. While we do not rely directly on Labor's survey, we do use it to get a sense of the potential losses because we agree that there is a strong possibility that a large number of pension-eligible employees will leave. Information provided by Verizon shows that **BEGIN CONFIDENTIAL** _________________ **END CONFIDENTIAL** employees slated to go to FairPoint at closing will be pension-eligible on January 31, 2008.[78] Using the survey results provided by Labor, if 68% of these employees opt for retirement if the Transaction is approved, FairPoint could lose **BEGIN CONFIDENTIAL**___ **END CONFIDENTIAL ** pension-eligible employees to retirement. This represents **BEGIN CONFIDENTIAL**____ **END CONFIDENTIAL ** of the total number of Verizon

[78] Eligibility estimates based on 9/1/07 employee listing projected to 1/31/08 eligibility. Conf. Attach. to ODR OPA-5.

employees slated to go to FairPoint. Conf. Attach. to ODR-OPA-5. Interestingly, this would almost negate the 675 new employees FairPoint plans to hire to meet the service quality commitments it has made in this case.

We are also concerned that the Employee Matter Agreement states that, beginning in January of 2007 and continuing for one year after the Transaction closes, FairPoint is not permitted to hire a Verizon employee who voluntarily leaves for a period of six months after the person leaves Verizon, *unless mutually agreed upon by both parties.* (emphasis added) Attachment SES-3 to Smith Dir. Thus, if Verizon decides it will not allow FairPoint to hire workers who leave Verizon as a result of the approval of the Transaction, FairPoint would be hard pressed to find replacement workers, especially for the more technical positions. Mr. Nixon stated during the hearings that, in the event of a mass exodus of employees, he would not hesitate to request permission from Steve Smith to hire employees that leave Verizon. Tr. 10/04/07 at 148. However, when asked at the hearing if he received such a request from FairPoint what he would do, Mr. Smith stated, "I do not know what my answer would be. We would need to discuss that at the time." Tr. 10/04/07 at 373. In light of Verizon's refusal to commit to granting FairPoint permission to hire former Verizon employees in the event of a significant loss of employees to retirement, we recommend that the Commission find that FairPoint's ability to provide reasonable service quality, as well as its ability to properly operate its business, could be severely impacted by the loss of pension eligible employees if the Transaction is approved.

In the event the Commission approves the Transaction, we recommend that the Commission consider several measures that could be taken to minimize the possibility of a large exodus of pension-eligible employees, or at least mitigate the impact of such an exodus. First, the Commission could condition its approval on Verizon allowing FairPoint to hire former Verizon employees without any waiting period. Second, the Commission could require Verizon to continue to provide services pursuant to the TSA at a reduced cost beyond the six month no cost period recommended in the Back Office Systems Section above (Section VI(B)) until such time that FairPoint can hire employees to replace the employees who choose to retire. Finally, the Commission could adopt Labor's recommended condition that FairPoint be required to develop a plan to address the potential loss of experienced workers.

We are also concerned about an issue not raised by any other party - Verizon's "realignment plan" as it relates to the operation of its call centers. We are concerned with FairPoint's reliance on Verizon to adequately staff its call centers in Maine after closing and that FairPoint may not have sufficient staff to handle customer calls. Although this issue was discussed during the hearings and in an oral data request, we are not sufficiently clear regarding the mechanics of the process to recommend that the Commission make a finding that FairPoint's call centers will (or will not) be adequately staffed after the closing. Because Verizon is responsible for properly staffing FairPoint's Maine call centers pursuant to its realignment plan, we believe that it should continue answering customer calls on FairPoint's behalf at no cost (pursuant to the TSA) until such time as it complies with the call center metrics contained in the SQI recommended by the Examiners in this case (see Appendix 2).[79] It was recommended in Section VI(B)

[79] The Examiners recommended metrics for the call centers based on the percent of customer calls to the business office and to repair that are not answered by a live customer service representative within 20 seconds.

(back office systems) that Verizon provide services pursuant to the TSA at no cost to FairPoint for a period of six months. This six month period should provide the necessary time to determine if Verizon has indeed properly staffed Maine's call centers. If Verizon fails to meet the call center metrics during the six month period, Verizon should continue to answer calls for FairPoint after the end of the six month period until such time as it meets both call center metrics for a period of three consecutive months. The Commission should also require Verizon/FairPoint to submit monthly reports depicting key call center statistics beginning immediately after closing to allow monitoring of Verizon's performance.

E. Back Office Systems

This issue is thoroughly discussed in Section VI (C) of this Report, therefore, we will not repeat that discussion here. We do wish to point out, however, that this is a major area of concern for the parties, as well as for the Examiners, due to its potential to severely impact service quality if the cutover process does not go smoothly or if the new systems do not operate properly.

F. Efforts to Improve Verizon's Service Quality

1. Positions of the Parties

a. FairPoint

FairPoint acknowledges that Verizon has experienced problems with meeting several requirements of the current SQI - installation appointments not met, repair appointments not met, trouble reports per hundred access lines, repeat trouble reports and, most significantly, the percent of residential troubles not cleared within 24 hours. Harrington/Brown/Smee Reb. at 11. FairPoint asserts that it will take several actions to improve performance in these areas. First, it will ensure that the scheduling of repair dispatches is properly prioritized, including extending hours of dispatch as necessary. Second, it will ensure the retention of adequate technician staff to handle the volume of trouble reports and installation requirements. *Id*. FairPoint further asserts that it will add at least 20 outside plant installation and maintenance technicians in Maine to the FairPoint work force. Harrington/Brown/Smee Reb. at 11-12. In addition to acknowledging the need to improve Verizon's service quality in the areas described above, FairPoint has also agreed to abide by the requirements of the current SQI applicable to Verizon and asserts that the current penalty structure is sufficient to motivate FairPoint to address these service quality problems. [80] Nixon Reb. at 34.

FairPoint claims that it has reviewed wire center level data on customer trouble reports rates, including the Code 4 report[81] rates, and determined that the vast majority of wire centers in Maine are delivering service with trouble report rates at or better than

[80] Verizon Maine currently operates under a Service Quality Index (SQI) established in Docket No. 99-851 and imposed by the Second AFOR and contains 15 performance metrics. Each metric has a benchmark that Verizon must meet to avoid paying a rebate to customers for below-standard service quality. The SQI does not provide for any reduction in a customer rebate if Verizon's performance is better than a metric's benchmark. The rebate amounts for each metric are added together to calculate the total annual SQI rebate amount. The rebate amount for each metric is capped at $1.135 million, except that the "Major Service Outages" metric is capped at $2.27 million. The total annual SQI rebate is limited to $12.5 million in any one year. *Investigation Into New Alternative Form of Regulation for Verizon Maine Pursuant to 35-A Sections 9102-9103, Examiner's Report (Revenue Requirement and Service Quality Issues)*, Docket No. 2005-155, May 9, 2007. Each of the SQI recommendations made by the parties uses the existing SQI as a starting point, then recommends either changes to existing metrics, new metrics, additional conditions related to service quality, or increased penalties.

[81] Code 4 report rates are those reports associated with outside plant. Tr. 10/02/07 at 188.

target levels.[82] Harrington/Brown/Smee Reb. at 11 – 12. FairPoint acknowledges that the report rates for some wire centers indicate a need for proactive maintenance and outside plant refurbishment or replacement and that it plans to target the particular wire centers that are contributing the most trouble reports. Harrington/Brown/Smee Reb. at 13. FairPoint claims that it will identify which specific garage locations will require the additional headcount to meet the residential trouble reports cleared metric, while maintaining acceptable performance at the other garage locations. Harrington/Brown/Smee Reb. at 12. FairPoint asserts that as it drives down the number of trouble reports, service quality will improve and FairPoint can make the technicians more readily available to meet the 24-hour repair, installation and repair appointment commitments. *Id*.

FairPoint further states that the wire centers that require refurbishment represent approximately 10% of the total wire centers in Maine. *Id*. FairPoint claims that "[a]nother set of wire centers - approximately an additional 10% of the wire centers - have generated report rates which vary from on target to missing target, from month to month, with little apparent pattern. These wire centers require more detailed analysis, possible only after close with full access to all plant and trouble report data, to determine if infrastructure improvements are required." *Id*. FairPoint claims that both sets of wire centers are predominantly smaller ones serving fewer than 2,500 lines. *Id*.

FairPoint concludes that the total cost of hiring 20 additional outside plant technicians and the wire center refurbishment fits within the capital spending plan

[82] The "target rates" that FairPoint refers to is the "network trouble report rate" contained in Verizon's current AFOR SQI. The benchmark for this metric is 1.08 trouble reports per 100 customers.

FairPoint has developed for Maine. Harrington/Brown/Smee Reb. at 14. According to FairPoint, it will increase the capital expenditure per switched access line from the **BEGIN CONFIDENTIAL ___**END CONFIDENTIAL Verizon spent in 2005 and 2006 to **BEGIN CONFIDENTIAL** _____ **END CONFIDENTIAL** per line per year from 2008 through 2012. Leach Dir. at 32. FairPoint asserts that this increase will provide sufficient funds to cover the wire center refurbishments. ADV Ex. 159.

b. OPA

The OPA states that it does not appear that FairPoint has yet obtained a good working knowledge of Verizon's service quality performance and has not undertaken any detailed analysis of the actual performance data or what it would take to assure future compliance. Alexander Dir. at 29. The OPA further asserts that FairPoint claims that the Transaction will result in approximately $60 million to $75 million of synergy savings, yet FairPoint refuses to allocate any of the savings to improve service quality. OPA Br. at 62. The OPA argues that this savings goal may create internal pressure to achieve these savings at the expense of investment in network reliability, maintenance services, and customer care expenses at the call centers. OPA Br. at 55. For this reason, the OPA recommends that the Commission convert FairPoint's vague promises about service quality into enforceable obligations as conditions on any approval of the Transaction. OPA Br. at 62.

The OPA makes five general service quality-related recommendations that should be imposed as conditions on FairPoint in the event that the Commission approves the Transaction. Those conditions include the following:

- Immediate adoption of the Verizon SQI with modifications that reflect recent experience with respect to Verizon's compliance with its applicable SQI, including increased penalties;[83]
- Adoption of an SQI for FairPoint "classic" companies so that service quality for local exchange customers in those service areas does not deteriorate during the merger and transition period;
- Require that FairPoint submit a unified SQI for all FairPoint operations in Maine at the time when all the FairPoint operations are combined;
- Imposition of a new billing metric to apply to all FairPoint companies in Maine because the current SQI does not include such a billing error metric, and because the risks associated with the changes in FairPoint billing systems for both its new Verizon and classic FairPoint customers have been clearly identified; and
- Require FairPoint to develop a plan to eventually improve service quality in all FairPoint's Maine companies, in response to FairPoint's repeated promises to "improve" and deliver "outstanding" service quality to its Maine customers.

The OPA asserts that the SQI designed for FairPoint must reflect not only the risks associated with this particular Transaction, but it must also take into account the "poor service quality" that FairPoint will inherit from Verizon-Maine and that it is essential that FairPoint be required to implement a specific service plan that will make available resources that are needed to improve on the inadequate levels of service quality that Verizon has delivered in recent years. OPA Br. at 52 – 54.

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[83] The OPA recommends that the Commission require FairPoint to file a proposal for a graduated penalty that would apply to the "residential repair appointments not met" and "network trouble reports per hundred access lines" metrics during a two year period after the close. The existing penalties for the other metrics should remain in place. Following the end of this period, if FairPoint has not yet met the performance standards for all the metrics, than the escalating penalty provision for consecutive annual misses should be adopted. Alexander Sur. at 4.

c. Labor

Labor argues that FairPoint will need to correct problems left behind by Verizon to maintain service quality and customer service and that this will require additional capital and personnel. Labor Br. at 24. Labor goes on to say that Verizon has failed to meet reasonable, minimum standards of performance in several areas of its operations and that this will create problems for FairPoint in trying to provide customers with reliable service. Labor Br. at 26. Labor bases this conclusion on its review of federal ARMIS data collected between 2001 and 2006. *Id.* at 24. According to Labor, this data shows that "complaints per one million lines" in Maine increased from 75 in 2001 to 171 in 2006; "average installation intervals in days" increased from 0.8 days in 2001 to 1.2 days in 2006; and "out-of-service repair interval" increased from 18.1 hours in 2001 to 25.5 hours in 2006. Finally, repeat troubles as a percent of initial out of service troubles, increased from 10.9% in 2001 to 14.1% in 2006. *Id*.

Labor further argues that FairPoint's ability to improve service quality will be constrained, if not undermined, by inadequate resources. Peres Dir. at 25. Labor states that the service quality risks associated with FairPoint's financial situation are compounded by FairPoint's lack of comprehensive knowledge of Maine's plant and if significant portions of Verizon's infrastructure require upgrades beyond those assumed in FairPoint's financial planning, the pressure on FairPoint's ability to meet its investment requirements will increase. Labor Br. at 27.

Labor concludes that FairPoint's "constrained financial situation" will undermine its ability to achieve and maintain high quality service levels. Labor Br. at 35. Labor asserts that 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 and that FairPoint will not have the financial resources to accomplish this task. *Id*. Labor states that if the Commission believes that FairPoint's severe financial deficiencies can be overcome, then in the alternative, the Commission should consider approving the Transaction only with stringent conditions to ensure that service quality is improved and backed up by financial consequences sufficient to avert a "pay to play" response from FairPoint management. *Id.* at 38.

The conditions recommended by Labor are:

- Establish a Service Quality Index plan with penalties as a condition of the merger that will extend from the date of the closing of the Transaction to five years following the "cutover" from Verizon to FairPoint.
- Adopt a new Duration of Outages Standard of 17.5 hours.
- Strengthen the Penalty-Rebate mechanism, as shown in Table Seven on page 34 of Dr. Peres' testimony.
- Require a comprehensive service quality performance audit if FairPoint fails to meet any individual transaction SQI benchmark for three consecutive years.
- Require FairPoint to develop a detailed plan to address the likelihood that a significant number of workers may leave their current employment if the Transaction is approved. This plan should specifically identify the number, job title and location of likely job losses, map out a plan for backfilling positions, and training replacements.

d. Verizon

Verizon asserts that there is substantial evidence before the Commission demonstrating that its network is performing well and that, overall, Verizon is providing good quality service to its customers. VZ Br. at 4. Consequently, the current level of retail service quality poses no impediment to FairPoint's ability to operate the Maine business or to make good on its commitment to improve service quality, and there is no basis for imposing any service quality related conditions on approval of this Transaction. *Id.* Verizon bases its assertion on three factors: its performance under its AFOR; consumer surveys; and ARMIS data.[84] VZ Br. at 16. Regarding its performance under its AFOR, Verizon states it is measured in 15 separate areas of retail service quality for which it might incur a penalty, for a total of 75 service quality observations over the five-year measurement period. VZ Br. at 14. During that time, Verizon Maine met or exceeded the baseline standards for 57 of the 75 observations. *Id.* Verizon argues that the service quality measures were never intended by the Commission to serve as industry measures of "good" or "acceptable" service, thus, missing an SQI metric does not mean that Verizon's service quality is poor or unacceptable. VZ Br. at 14-15.

Regarding its customer surveys, Verizon asserts that its Customer Care Index (CCI) satisfaction surveys provide further evidence that the service quality concerns expressed by the OPA and Labor are exaggerated. Verizon states that from 2002 through June of 2007, Verizon customers overwhelmingly judged their interaction with Verizon as satisfactory or better for each of the survey's installation, repair, and customer inquiry measurements. VZ. Br. at 15. Verizon concludes that these results demonstrate that the vast majority of Verizon Maine's customers find that Verizon has provided good quality service that meets or exceeds their expectations. *Id.*

Regarding the ARMIS data, Verizon asserts that data proffered by Labor, which depicts the rate of customer complaints per million lines, distorts Verizon's performance because the absolute number of complaints remains extremely low. Verizon goes on to assert that a comparison of ARMIS data shows that Verizon's performance in

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[84] "ARMIS" is the FCC's Automated Reporting Management Information System.

comparison to all reporting ILECs shows Verizon to be in the top 20% of companies. VZ Br. at 15.

2. Recommendation

We find that a review of Verizon's service quality results under the current AFOR reveals that service quality has declined. As shown in Table 1, Verizon missed the benchmarks for six metrics in 2002/03 and five metrics in 2003/04. Four of the same metrics were missed in both years: Premise Repair—Appointments Not Met; Mechanized Repairs—Appointments Not Met; Held Orders—Average Delay Days; and Residential Troubles Not Cleared Within 24 Hours. Verizon missed the benchmarks for two metrics in 2004/05 and three metrics in 2005/06. Finally, in 2006/07 Verizon's service quality performance missed the benchmark for six metrics (Premise Installations—Appointments Not Met; Premise Repairs—Appointments Not Met; Customer Trouble Reports; Repeat Trouble Reports; Business Trouble Reports Not Cleared, and Residential Troubles Not Cleared).[85] The increase in missed metrics indicates that Verizon's performance is getting worse. In fact, the penalty amount incurred by Verizon for the 2006/2007 AFOR reflects the highest penalty ever incurred by Verizon since the creation of its AFORs in 1995.[86]

[85] Verizon's service quality data cited in this report for the 2006/2007 AFOR year includes statistics for the month of April, which Verizon has requested be exempted from the overall calculations due to severe snow storms. *Request for Waiver of 2007 Service Quality Results for April, 2007 Related to the April 4 and Patriots Day Nor'Easter*, Docket No. 2007-444. We wish to note that even if Verizon's exemption request is granted, it would still miss each of the benchmarks it missed without the waiver.

[86] In the event Verizon's exemption request is granted, the penalty would be reduced from $1,224,708 to $1,037,601.

Table 1: Verizon's SQI Performance 2001-2007

	Benchmark	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07*
Customer Service							
Premise Installations % Appts Not Met Co. Reasons	12.64%	8.53%	10.65%	10.62%	8.68%	9.78%	**15.59%****
Mechanized Installations % Appts Not Met Co. Reasons	0.10%	0.04%	0.06%	0.03%	0.07%	0.07%	0.07%
Premise Repairs % Appts Not Met Co. Reasons	16.11%	14.23%	**16.58%**	**17.36%**	13.62%	13.92%	**19.52%**
Mechanized Repairs % Appts Not Met Co. Reasons	7.21%	6.26%	**9.02%**	**7.33%**	4.76%	5.02%	5.03%
Held Orders Avg Total Delay Days	6.21	5.46	**6.52**	**6.34**	5.57	5.91	3.93
Business Office Calls % Answered Over 20 Seconds	31.00%	19.72%	24.00%	23.00%	21.00%	24.00%	27.00%
Repair Service Calls % Answered Over 20 Seconds	23.10%	19.29%	**29.50%**	15.80%	10.20%	10.70%	13.70%
Service Reliability							
Customer Trouble Reports Rate per 100 Lines–Network	1.08	1.01	0.93	**1.11**	1.06	**1.16**	**1.20**

Repeat Trouble Reports Rate per 100 lines	0.12	0.08	0.09	0.11	0.11	**0.13**	**0.14**
% Troubles Not Cleared Within 24 Hrs. - Residence	21.10%	**24.10%**	**29.30%**	**34.30%**	**33.40%**	**37.80%**	**41.00%**
% Troubles Not Cleared Within 24 Hrs. - Business	9.00%	6.30%	7.90%	7.80%	7.60%	8.50%	**9.30%**
Dial Tone Speed % Over 3 Sec.	0.36%	0.05%	0.03%	0.03%	0.03%	0.02%	0.01%
% Blocked Calls	0.03%	0.01%	0.00%	0.00%	0.00%	0.00%	0.00%
Major Service Outages	614	253	404	333	132	92	361
Customer Satisfaction							
PUC Complaint Ratio	0.52	**0.76**	**0.61**	0.52	**0.66**	0.50	0.45

*Reflects 12 months of date without exclusion of April.
**Bolded statistics represent metrics that missed the benchmark.

One of the most concerning aspects of Verizon's performance under its AFOR is the Residential Troubles Not Cleared metric. Verizon has not met the benchmark for this metric during any year of the Second AFOR and often, particularly since 2003/04, it has missed that benchmark by wide margins (more than 50% in excess of the benchmark). Last year and this year, the performance is even worse. Verizon missed the benchmark by 79% in 2005/2006 and by over 94% in 2006/2007. As shown in

Table 2, Verizon's performance in clearing residential troubles has been progressively worse during the period of the Second AFOR.

Table 2: Verizon's Performance in Clearing Residential Troubles

AFOR Year	% Worse than Benchmark
2001/02	14%
2002/03	39%
2003/04	63%
2004/05	58%
2005/06	79%
2006/07	94%

As noted in the Examiner's Report issued in Docket No. 2005-155, Verizon's failure to meet the Residential Troubles Not Cleared benchmark suggests it is possible that Verizon Maine may not have enough maintenance and repair technicians to keep up with its residential customers' service troubles.[87] *Investigation Into New Alternative Form of Regulation for Verizon Maine Pursuant to 35-A Sections 9102-9103,* Examiner's Report (Revenue Requirement and Service Quality Issues), Docket No. 2005-155 (May 9, 2007). We are encouraged by FairPoint's plan to hire additional outside plant technicians and to prioritize repair dispatching, and while these actions should improve performance on this metric, we do not know if these actions will improve performance to a level that is reasonable if the Transaction is approved.

In light of the problems Verizon has experienced, we believe that it will be a challenge for FairPoint to meet its commitment to provide high levels of service to its customers. We agree with Labor that FairPoint's ability to improve service quality will hinge on its available resources, the level and experience of the workforce allocated to

[87] *See 2005 Service Quality Notices* (Docket Nos. 1999-851 and 2005-24); Request for Additional Testimony (April 14, 2006) in Docket No. 2005-155.

service quality, and the smooth transition to entirely new and integrated operational, administrative and support systems. We do not know if FairPoint's proposal for improving service quality will be adequate to meet the promises FairPoint has made, nonetheless, the proposal is a step in the right direction and does appear to cover all the necessary areas to meet their objectives. We also agree with the OPA that the risk of failure to provide reasonable and adequate service should be borne by the Applicants and their shareholders, not ratepayers. To accomplish this, we recommend that the Commission adopt the SQI proposed by the Examiners in the AFOR case (Recommended SQI) as a condition to this Transaction if the Commission decides on approval. The Recommended SQI is thoroughly described in Appendix 2.

Adoption of the Recommended SQI will help transfer the risk of poor service quality from ratepayers to shareholders, as recommended by the OPA, and will help ensure that FairPoint dedicates the necessary resources to maintaining service quality on a going forward basis. We do not agree with the OPA that the SQI should also apply to the existing FairPoint subsidiaries and recommend the Commission not adopt OPA's proposed condition. There has been no evidence presented in this case to demonstrate that those companies' service quality will be detrimentally impacted by the approval of this Transaction and, therefore, an SQI that applies to these companies is unnecessary. Further, we find that the measures proposed by FairPoint to maintain and improve service quality, as previously described in this Report, are reasonable and reflect an effort that Verizon has thus far been unwilling to undertake. Consequently, we recommend that the Commission adopt as a condition of any approval of the Transaction FairPoint's compliance with the Recommended SQI and the measures

FairPoint has proposed to maintain and improve service quality, i.e., hiring additional staff, refurbishing wire centers, and prioritizing repair dispatches.

The adoption of the Recommended AFOR SQI will result in FairPoint being exposed to significantly higher penalties than under the current SQI. In the Examiners' Report issued in Docket No. 2005-155, the Examiner concluded "[b]ecause the present penalty-rebate mechanism does not provide sufficient incentive for Verizon to improve its service quality, we will revise the penalty-rebate structure…as Verizon's performance worsens, the rebate it must pay customers increases more than proportionally." AFOR Examiners' Report at 268. We believe that it is appropriate for the higher penalties to also apply to FairPoint in this case for the same reason, i.e., the current penalty mechanism does not provide sufficient incentive to improve service quality. The increased penalties should help ensure that FairPoint does indeed commit the necessary resources to maintain and improve (where necessary) its service quality. In addition, under the Recommended SQI, penalty amounts will double for any metric for which FairPoint fails to meet in consecutive years and will triple for any metric for which FairPoint fails to meet for three consecutive years. Consequently, FairPoint could incur significantly higher penalties under the Recommended SQI than Verizon would incur with a similar miss under the current SQI. We again believe this is appropriate to ensure that the proper incentive is in place to motivate FairPoint to address either chronic or worsening service quality problems and not simply accept the associated penalties as a "cost of doing business."

We are also concerned that FairPoint has underestimated the cost to refurbish its wire centers with high trouble report rates and that FairPoint may not have the resources necessary to complete the needed refurbishments. As noted above, FairPoint estimates that it will cost $5 - $6 million to complete the refurbishments. ADV Ex. 158. Yet FairPoint also acknowledges that a more detailed analysis is necessary to determine if infrastructure improvements are required on a subset of the underperforming wire centers and that this analysis can take place only after closing when FairPoint *has full access to plant and trouble report data*. (emphasis added) Harrington/Brown/Smee Reb. at 13. Thus, it cannot accurately estimate the cost of any necessary wire center refurbishment until this additional analysis is completed. FairPoint also claims that the cost of completing wire center refurbishment is included in FairPoint's capital expenditure projections and that it believes its budget will be sufficient, given the significant increase in "per line capex" going forward as compared to historical Verizon amounts, to cover the refurbishment costs. ADV Ex. 159. However, if FairPoint does not have a good understanding of what will be necessary for wire center refurbishments and consequently what the cost of those refurbishments will likely be, then it cannot conclude that its "capex budget" will be sufficient to cover the refurbishment costs.

To address this issue, we recommend that, if the Commission does not accept OPA's recommendation to reduce the sales price by $600 million as discussed in Section IV of this Report, then it should consider requiring Verizon to place funds in an escrow account sufficient to cover the cost of completing the necessary wire center refurbishments. The amount necessary to cover the refurbishments can be determined after FairPoint is provided with the necessary access to Verizon's plant and records.

G. Summary of Recommendations

As discussed above, we have serious concerns regarding FairPoint's ability to meet the service quality commitments it has made or meet our recommended conditions. Indeed, we find the overall risk to service quality presented by the Transaction is great. However, if the Commission decides to approve the Transaction, we recommend the Commission consider imposing the following conditions, as described above:

VIII-1	Require Verizon to grant FairPoint permission to hire former Verizon employees without any waiting period.
VIII-2	Require Verizon to continue to provide services pursuant to the TSA at a reduced cost beyond the six month no cost period recommended in the Back Office Systems Section above (Section VII(C)) until such time that FairPoint can hire employees to replace the employees who choose to retire.
VIII-3	Require FairPoint to develop a plan to address the potential loss of experienced workers.
VIII-4	Require Verizon/FairPoint to submit a monthly report depicting key call center statistics beginning immediately after the close and to require Verizon to continue answering customer calls at no cost after the six month TSA period if Verizon fails to meet the call center metrics contained in the staff recommended SQI during the six month TSA period. Verizon should continue to answer customer calls on FairPoint's behalf until such time as it complies with the call center metrics for at least three consecutive months.
VIII-5	Require FairPoint to comply with the Recommended SQI from Docket No. 2005-155.
VIII-6	Require FairPoint to meet the specific commitments it has made regarding hiring additional staff, refurbishing wire centers, and prioritizing repair dispatches.
VIII-7	If the Commission does not accept OPA's recommendation to reduce the sales price by $600 million, require Verizon to place funds in an escrow account sufficient to cover the cost of completing the necessary wire center refurbishments.
VIII-8	If the Commission decides an SQI is not necessary as a condition, require Verizon to improve its performance regarding the "Repair Reports Not Cleared in 24 Hours – Residential" service quality metric through the creation of the escrow account referenced above.

VIII. FEDERAL REGULATORY ISSUES

There are three distinct categories of federal issues related to this Transaction that require our attention: (a) the price cap carrier waiver; (b) federal access rates and the federal subscriber line charges; and (c) the level of federal universal service funds. Despite the importance of these issues, FairPoint presented very limited testimony and evidence regarding the issues at any stage of this case. FairPoint's responses to Advisors' data requests and questions asked during the July technical conference and October hearings reflect a lack of consideration regarding the implications of the federal issues discussed in this section. Furthermore, FairPoint's primary federal issues witness, Michael Skrivan, did not include any testimony directed to these issues in his Rebuttal Testimony filed on August 22, 2007.

FairPoint's diligence in pursuing additional federal revenue sources and in addressing the other federal issues we have raised is a disappointment, especially given that the parties have pointed out other areas where FairPoint has not been aggressive in pursuing additional revenue opportunities that could help make this Transaction more viable. Nevertheless, because of their importance, we will address these federal regulatory issues and their impact on our overall assessment of this Transaction.

A. Price Cap Carrier Waiver

The price cap waiver issue is covered by several provisions of the FCC's rules. Under the provisions of 47 C.F.R. § 61.41(b):

> If a telephone company, or any one of a group of affiliated telephone companies, files a price cap tariff in one study area, that telephone company and its affiliates, except its

> average schedule affiliates, must file price cap tariffs in all their study areas.

Furthermore, pursuant to 47 C.F.R. § 61.41(c)(2):

> (2) Where a telephone company subject to price cap regulation acquires, is acquired by, merges with, or otherwise becomes affiliated with a telephone company that is not subject to price cap regulation, the latter telephone company shall become subject to price cap regulation no later than one year following the effective date of such merger, acquisition, or similar transaction and shall accordingly file price cap tariffs to be effective no later than that date in accordance with the applicable provisions of this part 61.

FairPoint has indicated that it will retain price cap status for its acquired Northern New England properties, thus the "FairPoint Classic" properties will become subject to federal price caps unless the FCC grants a waiver of 47 C.F.R. § 61.41(c)(2). Tr. 10/10/2007 at 15. A transfer of FairPoint Classic from federal rate of return regulation to price cap regulation could adversely affect FairPoint Classic's revenues. The magnitude of that adverse financial effect will be quantified by FairPoint when it responds to ODR 21.

In recognition of the potential adverse effects, FairPoint has sought a waiver of the price cap rule from the FCC. As of the time of the hearing and the present day, the waiver has not been acted upon by the FCC.

If the Commission chooses to approve this Transaction, it should consider imposing a condition requiring FairPoint to obtain the waiver from the FCC before the Transaction closes. Indeed, if the FCC waiver is not granted, the Commission will have a difficult time making the necessary finding that the Transaction will not have a negative effect on the FairPoint Classic customers or owners as required by 35-A

M.R.S.A. § 708, because it is likely that FairPoint Classic will lose revenue if the waiver is not granted.

B. Federal Access Rates and the Federal Subscriber Line Charge

FairPoint appears to assume that, for at least the first year after the Transaction, it can retain Verizon's existing federal access rates and interstate Subscriber Line Charges (SLC). Tr. 10/10/2007 at 7. However, it has not cited any legal authority to support that proposition. Verizon's current price cap access rates for Maine include access costs for states that are not included in this Transaction, such as Massachusetts and Rhode Island. Because FairPoint's proposed service area does not include Massachusetts and Rhode Island, it is not clear that it can adopt Verizon's current federal access charges.

Under Part 69 of the FCC rules, federal access charges, including special access rates, may be developed for a single company or group of companies. However, we are not aware of any cases, aside from the NECA pool, where the FCC has allowed unaffiliated companies to pool costs for access purposes. Unless the FCC grants FairPoint the unusual authority to assume Verizon's price cap federal access rates, FairPoint will have to file its own access rates (including SLC rates) pursuant to the provisions of 47 C.F.R. §§ 69.1 to 69.73. Any such filing would necessarily be based upon FairPoint's costs and not Verizon costs. As discussed in the cross-examination of Michael T. Skrivan, FairPoint's SLC may increase when and if it files for its own access rates. Tr. 10/10/2007 at 10. This would be caused by a number of factors, including the fact that Verizon's SLC is not at the FCC capped amount because Verizon's costs include low cost states like Massachusetts.[88]

In its brief, the OPA suggested the following condition if the Commission were to approve this Transaction:

> FairPoint shall not seek to increase the SLC charge to residential or business customers above the current rates of Verizon before 2012.

We agree with the concept of the OPA's proposed condition but recommend a slightly more detailed version. Specifically, because FairPoint's access customers and end users who pay the SLC or special access charges could be adversely impacted by this Transaction, we recommend that the Commission consider prohibiting FairPoint from increasing its access rates, including special access rates or SLC rates, above those currently allowed for Verizon for four years - even if FairPoint is required to file its own rates.

C. Level of Federal Universal Service Funds

Section 54.305(b) of the FCC's rules contains the so-called "parent trap rule":

> . . . a carrier that acquires telephone exchanges from an unaffiliated carrier shall receive universal service support for the acquired exchanges at the same per-line support levels for which those exchanges were eligible prior to the transfer of the exchanges.

47 C.F.R. § 54.305(b). Under the "parent trap" an acquiring telephone company can get no more in per line USF support than would have been received by the selling

[88] Other factors make the exact magnitude of the possible change in access rates and SLC difficult to determine at this time. Tr. 10/10/2007 at 9. Mr. Skrivan agreed to provide further analysis with regard to the issue as ODR No. 20, which is not currently completed.

company. Thus, here, FairPoint, despite the possibility of it being considered a rural ILEC, is limited to the non-rural support Verizon receives today.

In its brief, the OPA suggested that the Commission should condition any approval of the Transaction on FairPoint obtaining an FCC waiver of the parent trap rule. While "rural" carriers generally receive more support than do "non-rural" carriers, that would not be the case for FairPoint's acquired properties. Even if the FCC were to grant a waiver of Section 54.305 and is willing to treat FairPoint as a "rural carrier" for its acquired exchanges, those exchanges would not receive a significant amount of additional support because Verizon's current embedded loop costs are relatively low, Tr. 10/10/2007 at 23, and because the acquired study area has over 200,000 lines (*see* 47 C.F.R. § 36.631). At the investment levels proposed by FairPoint, its USF support will not increase appreciably because its loop investment will still not substantially exceed the national average. Tr. 10/10/2007 at 23. The FCC's current cap of the loop support mechanism of the federal USF makes it even more difficult for FairPoint to obtain additional federal USF funding under the rural mechanism since the benchmark for high cost support is constantly increasing as other rural carriers invest in broadband loop investment. Accordingly, we do not recommend that the Commission adopt the OPA's proposed parent trap condition.

We believe that the best chance for FairPoint to obtain additional federal USF exists if the FCC changes the USF compensation mechanism for non-rural carriers. If the FCC modifies the cost proxy mechanism and/or lowers the high cost bench mark for non-rural carriers in response to federal court orders, FairPoint could receive substantial additional USF support. Thus, if the Commission chooses to approve this Transaction, we recommend that it encourage FairPoint to lobby the FCC for changes to the rural support mechanism and the high-cost benchmark.

D. Summary of Recommendations

In conclusion, we make the following recommendations:

XIII-1	Require FairPoint to obtain a waiver of the FCC's price cap rules before the Transaction closes.
XIII-2	Prohibit FairPoint from increasing its access rates, including special access rates or SLC rates, above those currently allowed for Verizon for four years - even if FairPoint is required to file its own rates.
XIII-3	Encourage FairPoint to lobby the FCC for changes to the rural support mechanism and the high-cost benchmark.

IX. ETC STATUS

Pursuant to 47 U.S.C. § 254(e) and 47 C.F.R. § 54.201(b), the Joint Applicants seek to have the Commission designate FairPoint as an Eligible Telecommunications Carrier (ETC) for the service area previously designated for Verizon. Pursuant to the FCC Order on Reconsideration, *In the Matter of Federal-State Joint Board on Universal Service, Ninth Report and Order and 18th Order on Reconsideration*, CC Docket No. 96-45 (FCC 99-306) released November 2, 1999, the Joint Applicants also ask the Commission to certify that FairPoint will use federal high-cost support in compliance with Section 254(e).

FairPoint witness Peter Nixon's Direct Testimony stated: "FairPoint will provide all the services necessary to quality as an ETC under the federal Communications Act." Nixon Dir. at 30; FP Br. at 23. While FairPoint has not provided any further detail, it is reasonable to conclude that FairPoint, if the proposed Transaction is approved, will continue to provide the services required of ETCs by federal law as Verizon does today. Similarly, FairPoint has not specifically stated that it will advertise the availability of, and prices for, such services but, again, we have no reason to believe FairPoint would not comply with the statutory requirements, especially given that FairPoint is an ETC in all of its FairPoint Classic service areas in Maine.

We also note that if FairPoint is designated as an ETC, FairPoint will also need to comply with Chapter 290 of the Commission's Rules, Standards for Billing, Credit and Collections, and Customer Information for ETCs Providing Basic Telephone Service, and Chapter 294, Lifeline and Link-Up Programs, of the Commission's Rules. Chapter 290 establishes consumer protections associated with local exchange service, many of which are required because ILECs are the "providers of last resort" for Maine's telephone users. Chapter 290 also requires ETCs to offer basic service at Commission established rates to any customer wanting service within its territory and Chapter 294 establishes obligations which provide financial assistance to qualifying low-income customers to obtain and receive basic telephone service.

FairPoint has not affirmatively stated that it will continue to offer qualifying low-income customers access to Lifeline and Link-Up programs required by Chapter 294 as Verizon does today. However, FairPoint has committed to adopt Verizon's rates in effect upon commencement of service by Telco as Telco's initial rates and a one-year stay-out on local rate changes. FP Br. at 7, 72-76 and Appendix C at C-3. We will therefore assume, unless informed otherwise in Exceptions, that this commitment includes Verizon's rate schedules regarding Lifeline and Link Up programs.

With respect to the Joint Applicants' request that the Commission certify that Telco will use federal high-cost support in compliance with Section 254(e), the request is premature until Telco begins providing service as an ETC.

Recommendation

Designation of FairPoint as an ETC, if the proposed Transaction is approved and Verizon relinquishes its ETC designation, is in the public interest as it will ensure that quality telecommunications services continue to be available to customers at just, reasonable and affordable rates. We recommend that the Commission explicitly condition any approval of the proposed Transaction on FairPoint's commitment to: 1) continue to provide the nine services supported by the USF that are required of ETCs; 2) advertise the availability of, and prices for, such services; 3) continue to offer Lifeline and Link-Up to customers and 4) use the USF funds it receives in compliance with 47 U.S.C. § 254(e).

X. PRIVACY ISSUES

A. Position of the Parties

1. Complainants

The Complainants (James D. Cowie, on behalf of the complainants in the *NSA Proceeding,* Docket No. 2006-274) contend that the Commission should retain its jurisdiction over the existing claims against Verizon in the *NSA Proceeding* by imposing a condition either on the proposed sale pursuant to Section 708 or on Verizon's abandonment or discontinuance of service pursuant to Section 1104. Cowie Br. at 1. The Complainants assert that as "a side benefit" of selling its wireline network in Maine, Verizon will avoid being held accountable for possible violations of Maine's telecommunications privacy statute (35-A M.R.S.A. § 7101-A), Maine's criminal telephone privacy statutes (15 M.R.S.A. §§ 709-713), and Verizon customers' rights under the 4th Amendment in the absence of such a condition. *Id.* at 6.

The Complainants also argue that the Commission should require FairPoint to strengthen its privacy policies. *Id.* at 9. In the alternative, the Complainants suggest that the Commission either open an investigation into FairPoint's privacy policy or commence a rulemaking to develop requirements for a comprehensive customer record privacy policy for Maine's telephone companies. *Id.* The Complainants also ask the Commission to consider whether the amount of FairPoint personnel dedicated to privacy issues is adequate given the increased size of its operations if the proposed Transaction is approved. *Id.* at 7-8.

2. Maine Civil Liberties Union Complainants (MCLU)

A separate brief was filed on behalf of Complainant Christopher B. Branson and other complainants in the *NSA Proceeding* who are members of the Board of Directors of the Maine Civil Liberties Union Board (MCLU) to address privacy issues of particular concern to the MCLU. MCLU Br. at 1.

The MCLU contends that the Commission can, and should, retain jurisdiction over Verizon in connection with the *NSA Proceeding*. First, the MCLU argues that there is nothing in Title 35-A that suggests that a utility can divest the Commission of jurisdiction to continue an on-going investigation simply by selling its assets or ceasing to do business in Maine. *Id.* at 4-5. The MCLU contends that Verizon's actions in 2006 and prior to that provide the Commission with both subject matter and personal jurisdiction to investigate Verizon in the *NSA Proceeding,* a fact which does not change if Verizon sells it assets in Maine. *Id.* While Verizon appears to argue that once it sells its assets it will no longer be subject to regulation by the Commission and that the Commission will lack the power to continue investigating Verizon, the MCLU contends that the Law Court rejected this argument when it explained that "[t]he scope of the Commission's authority to investigate is not limited by the scope of ultimate action that it may properly take". *Id*. at 5 (citing *CMP v. MPUC*, 395 A.2d 414, 426 (Me. 1978) (rejecting argument of CMP that the Commission could not investigate issues beyond the scope of the Commission's power to regulate)).

Second, the MCLU argues that Verizon will remain an affiliated interest subject to the Commission's jurisdiction after the sale providing the Commission with independent grounds for retaining jurisdiction over Verizon. *Id*. at 6. In the Joint Application, Verizon acknowledges that three of its affiliates, BACI, NYNEX Long Distance and VSSI, each subsidiaries of Verizon Communications, Inc., are telephone utilities in Maine as defined in 35-A M.R.S.A. § 102. *Id*. Furthermore, the MCLU notes that Verizon also acknowledges that VSSI will continue to do business in Maine and that NYNEX Long Distance and BACI are not seeking to terminate their authorization from the Commission to provide service in the State. *Id*. The MCLU also asserts that the Commission routinely requires affiliated interests, many of which are not Maine utilities and many of which conduct no business in Maine, to submit to investigation and regulation by the Commission under Section 707. *Id*. at 7 (citing *Competitive Energy Services v. PUC*, 818 A.2d 1039, 1048 (Me. 2003) (confirming that upon becoming an "affiliated interest" of a Maine "utility", an entity is then "subject to regulation" by the Commission)).

Third, the MCLU argues that the Commission may require Verizon to consent to the Commission's jurisdiction as a condition of approval of the proposed Transaction and supports the OPA's recommended condition in this regard. *Id*. at 7.

The MCLU also maintains that the Commission should require FairPoint to adopt stronger privacy policies and procedures which reflect Maine's telecommunications privacy policy. *Id*. at 9-12 (quoting 35-A M.R.S.A. § 7101-A(1) ("Telephone subscribers have a right to privacy and the protection of this right to privacy is of paramount concern to the State."))

The MCLU asserts that FairPoint's privacy policy does not prescribe any particular practices or technologies for protecting customer privacy, makes no mention of any particular security measures or devices to be used with paper files or computer records, and does not provide any instructions about who may receive and respond to legal orders or how requests are evaluated to determine their legitimacy. *Id*. at 11. The MCLU also expresses concern that FairPoint's policy requires an annual internal review but FairPoint admittedly has no records of any such review for the past five years. *Id*. at 12.

Finally, the MCLU maintains that in light of the State's concern for customer privacy as reflected in Section 7101-A, it would be appropriate for the Commission to require greater scrutiny and care on the part of Maine telephone companies in responding to requests for information. *Id*. at 13.

3. <u>OPA</u>

The OPA argues that Verizon should not be allowed to escape potential liability or the Commission's jurisdiction as a result of Commission approval of the proposed Transaction. OPA Br. at 93. The OPA argues that the federal courts may remand the case to the Commission or the stay of the Commission's investigation may be lifted and, therefore, it is essential that the Commission impose a condition upon Verizon's abandonment of service requiring Verizon to agree to submit to the Commission's continued jurisdiction over Verizon and its ILEC records in the *NSA Proceeding*. *Id*.

4. Verizon

Verizon argues that the Commission will not have jurisdiction over Verizon if the proposed Transaction is approved. VZ Br. at 18. Verizon asserts that "[i]t is elementary that the Commission's jurisdiction is that which has been granted to it by the Legislature" and that following the closing, "Verizon Maine simply will no longer be 'offering…a service that transmits communications by telephone' in Maine under 35-A M.R.S.A. § 102(18) and will therefore no longer be a telephone utility subject to the jurisdiction of the Commission." *Id*. Finally, Verizon further argues that the Commission cannot create jurisdiction where none exists, and Verizon will not voluntarily submit to the jurisdiction of the Commission following closing for purposes of resolving the *NSA Proceeding*. *Id*.

5. FairPoint

FairPoint maintains that, after closing, Verizon will operate the network in Maine and will not be subject to Commission oversight with respect to privacy issues. FP Br., Appendix E at E-3.

B. Recommendation

Title 35-A M.R.S.A. §§ 101-121 outline the general purpose of Title 35-A (to ensure that there is a regulatory system for public utilities in Maine and assure safe, reasonable and adequate service at rates that are just and reasonable to customers and public utilities); discuss the Commission's powers and duties (including the power to obtain information and investigate matters related to public utilities); and provide that the provisions of Title 35-A will be construed liberally to accomplish its purposes and that the Commission has all the implied and inherent powers which are necessary and proper to execute faithfully its express powers and functions.

More specifically, Section 103(A) provides that "[a]ll public utilities are subject to the jurisdiction, control and regulation of the commission." 35-A M.R.S.A. § 103(A). Section 115 provides that the commission "shall inquire into any neglect or violation of state laws by a public utility doing business within the State… enforce [Title 35-A] and all other laws relating to public utilities…." 35-A M.R.S.A. § 115. Section 1302 sets forth the Commission's authority to investigate complaints against public utilities that certain utility practices are unreasonable, and Section 1303 provides that the Commission "may on its own motion, with or without notice summarily investigate" when it believes that "[a]n investigation of any matter relating to a public utility should for any reason be made." 35-A M.R.S.A. §§ 1302, 1303. Sections 1501-1512 provide that the Commission may impose sanctions or penalties for violations of Title 35-A.

Telephone subscribers have a "right to privacy and the protection of this right to privacy is of paramount concern to the State." 35-A M.R.S.A. § 7101-A(1). Section 7101 further provides "to exercise their right to privacy, telephone subscribers must be able to limit the dissemination of their telephone numbers to persons of their choosing." 35-A M.R.S.A. § 7101-A(2). In addition, the Commission's Rules provide that telephone carriers operating in Maine "shall comply with the FCC's Customer Proprietary Network Information (CPNI) Rules, 47 CFR §§ 64.2001-2009"[89] and "shall not engage in conduct

[89] Chapters 290, 291 and 292, Standards For Billing, Credit and Collection and Customer Information For Eligible Telecommunications Carriers, Non Eligible

prohibited by the Maine Unfair Trade Practices Act … and related consumer protection statutes."[90]

NYNEX Long Distance, BACI and VSSI are active public utilities in Maine. While Verizon New England will terminate its authority to operate in Maine if the proposed Transaction is approved, the Joint Applicants have stated throughout this proceeding that VSSI will continue to operate in Maine and that BACI and NYNEX Long Distance are not seeking to terminate their authorization to operate in Maine. FP Br. Appendix A at A-5. Accordingly, there is no question that the Commission has regulatory jurisdiction over these utilities.

While we believe that the Commission likely has continuing jurisdiction over the existing claims against Verizon in the *NSA Proceeding* as argued by the MCLU, we nevertheless recommend that the Commission, pursuant to section 708 (approval of the Transaction) and 1104 (approval of Verizon's abandonment), require Verizon to continue to be subject to the Commission's jurisdiction for purposes of the existing claims in the *NSA Proceeding*. In the alternative, we suggest that the Commission require Verizon to indemnify FairPoint for any penalties that the Commission might impose if the *NSA Proceeding* ultimately ends up back at the Commission for decision.

We note that the Commission may impose conditions or requirements on Verizon as part of Verizon's request to discontinue service that are necessary to protect the public interest. It is in the public interest that the Commission retain jurisdiction to

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Telecommunications Carriers, and Interexchange Carriers, Section 7 (Customer Privacy).

[90] Chapters 290, 291 and 292, Standards For Billing, Credit and Collection and Customer Information For Eligible Telecommunications Carriers, Non Eligible Telecommunications Carriers, and Interexchange Carriers, Section 6B (Unfair or Deceptive Trade Practices, Application of Maine Unfair Trade Practices Act).

investigate this matter for purposes of determining whether Maine's telecommunications customers' privacy rights were violated. Moreover, Section 1104 Section specifically provides that Verizon, as the public utility abandoning its plant or discontinuing service pursuant to authority granted by the Commission under Section 1104 is deemed to have waived all objections to the conditions or requirement imposed by the Commission in this regard.

We further recommend that, pursuant to section 708, the Commission condition approval of the proposed Transaction on FairPoint's reviewing its privacy policy and practices to specifically consider whether changes may be necessary, given the increased size of FairPoint if the proposed Transaction is approved. FairPoint should be required to report back to the Commission in six months, at which time the Commission will determine what further action to take with respect to FairPoint's privacy policies and the broader issue of privacy policies for all telecommunications providers that do business in Maine.

Finally, with respect to the requests by the Complainants and the MCLU to take official notice of certain documents,[91] we recommend that the requests be denied as

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[91] The Complainants and MCLU requested that the Commission take official notice of the following documents:

(1) The Director of National Intelligence's August 21, 2007 interview with the *El Paso Times*, filed September 21, 2007, in which he made public what had been held to be a "state secret" that AT&T and Verizon are cooperating "partners" with the NSA in its warrantless wiretapping programs. Cowie Br. at 3-4.

(2) A Washington Post article and Verizon letter responding to questions from the House Energy and Commerce Committee in which the Complainants allege that Verizon admitted providing customers' telephone records without court orders and which allegedly contained other information on Verizon's provision of customers' call records, including information on its dealings with the FBI's issuances of National Security Letters. *Id*. at 4.

being beyond the scope of Complainants' intervention. *See* Procedural Orders dated October 1, 2007.

Accordingly, we recommend the Commission consider the following conditions:

X-1	Require Verizon to continue to be subject to the Commission's jurisdiction for purposes of the existing claims in the *NSA Proceeding*. In the alternative, require Verizon to indemnify FairPoint for any penalties that the Commission might impose if the *NSA Proceeding* ultimately ends up back at the Commission for further processing.
X-2	Require FairPoint to review its privacy policy and practices to specifically consider whether changes may be necessary and report back to the Commission in six months.

XI. OVERALL RECOMMENDATION REGARDING 708 ISSUES

A. The Proper Standard

As described earlier, 35-A M.R.S.A §708(2)(A) allows the Commission to approve a reorganization akin to that requested by the parties in this proceeding if "it is established by the applicants for approval that the reorganization is consistent with the interests of the utility's ratepayers and investors." To date the Commission has applied a "no harm" standard, suggesting that the interests of shareholders and ratepayers are consistent with the interests of the applicants seeking reorganization as long as shareholders and ratepayers will be no worse off after the transaction than they were before.[92] OPA asks the Commission to expand the definition of aligned interests somewhat, by assuming that Section 708 should be read to rely upon other sections of the statute that promote, among other things, universal service and expanded advanced

(3) Verizon's Data Responses to Complainants' questions regarding the Commission's post-sale jurisdiction over it in the *NSA Proceeding*. *Id*. at 5.

(4) Department of Justice Inspector General Report on FBI Abuse of Issuance of National Security Letters. MCLU Br. at 1-2.

[92] See various supporting cites in the "Maine Law" section of this Report.

services proliferation (e.g., Sections 101 and 7101). OPA Br. at 9. It should be further noted, that whatever the underlying standard, Section 708 also places a responsibility on the Commission to implement, if necessary, conditions that foster several important policy objectives, prominent among them the financial viability of the surviving utility and ensuring the continued availability of "safe, reasonable and adequate service." 35-A M.R.S.A §708(2)(A).

Throughout the Report to this point we have described our recommendations related to the various particulars of the Joint Applicants' proposed Transaction, and, where necessary, have recommended conditions the Commission should consider if it chooses to approve the Transaction. In this section we weigh those various concerns with potential benefits and reach an overarching conclusion as to whether, in our opinion, the Joint Applicants have indeed established that their proposed "reorganization is consistent with the interests of the utility's ratepayers and investors." Before we reach such a conclusion, however, we must address OPA's recommendation to impose a standard more strenuous than the "no harm" standard generally relied upon. We do not recommend that the Commission accept the OPA's proposal.

While public policy objectives iterated elsewhere in Maine statute are, by definition, important regulatory policies that the Commission must keep in mind, to the extent the Legislature did not specifically describe them as considerations to be weighed in approving reorganization applications, we believe it is unnecessary to include them as specific requirements in reaching a final decision. We do not believe public policy objectives like those advocated by the OPA, such as expanded availability of advanced services including "data and image-based services," or "affordable rates," need be necessarily absent from the Commission's decision. The existing "no harm" standard is, by definition, a weighing of potential risks or disadvantages inherent within a proposed transaction, with potential advantages that will accrue to ratepayers and shareholders. It is our opinion, that the continued availability of affordable rates, increased access to advanced services and all the other policy objectives highlighted by the OPA can easily be accommodated via the Commission's decision in this case using the simple "no harm" standard.

For example, FairPoint has itself highlighted its intention to increase broadband investments as a potential benefit that would offset risks, and in FairPoint's opinion, sway the balance such that its proposed reorganization falls at least within the realm of "no harm." Similarly, risks related to FairPoint's substantially increased debt-leverage and its impact on FairPoint's ability to provide "affordable rates" pushes the balance toward "harm" for ratepayers and shareholders, and if left unbalanced, might require that the Commission reject the Joint Applicants' proposal. As such, we believe that OPA's concerns for an expanded standard are unnecessary given the already substantial latitude afforded the Commission in applying the "no harm" standard.

B. Our Primary Conclusion

When we apply the "no harm" standard to the record evidence available in this case we believe that, on the whole, the Joint Applicants have failed to establish that the reorganization proposal they put forward serves the interest of both ratepayers and shareholders. As such, we would recommend that the Commission deny the Joint Applicants' request as filed. We think the Commission's Advocacy Staff may have said it best as follows:

> The simple fact is that the debt in this deal is too great. FairPoint, after closing, would be a highly leveraged company and the risks of financial failure are too severe.

Advoc. Br. at 2

Throughout this Report, we have indicated that the Commission must perform a complicated and important balancing test. It must weigh on the one side the risks arising from substantially increased debt within the surviving utility's capital structure combined with revenue projections that are, in our opinion, too aggressive and not based upon realistic assumptions about the marketplace, as well as the very real possibility of direct customer-impacting problems if the transition and cutover are not executed with exacting precision. Also, in our opinion, FairPoint's expense and capital spending projections have a real possibility of being understated, and in that event, FairPoint's financial stability could be threatened, since its options are fairly limited. On the other side, it must weigh potential advantages accruing from a more locally focused organization with stated objectives of increased broadband deployment, expanded employment (at least initially), economic development initiatives, and state-of-the-art back office systems. We have attempted herein to weigh those various concerns and benefits, quantifying where possible what we believe are the most likely outcomes. Yet having done our own analysis, we agree with the Advocacy Staff, OPA, Labor and others that the scale tips toward the side of excessive risk unbalanced by sufficient concurrent benefits. As such, we do not believe that the Joint Applicants have sufficiently demonstrated that either shareholders or ratepayers will escape harm if the Transaction is approved.

C. Conditions

As indicated by Section 708(2)(A), conditions imposed by the Commission can go a long way toward meeting the standard for approval for a transaction. We believe that the parties in this proceeding, FairPoint perhaps as much as anyone, have participated in good faith in an effort to identify conditions that would help allay some risks, thereby shifting the scale back toward an even keel. Throughout this Report we have identified for the Commission those conditions which we believe have merit, and which would isolate (or at least mitigate sufficiently) the potential risks in such a fashion that they could help to meet the "no harm" standard. (All proposed conditions are summarized in Appendix 3 below.) Ultimately, the Commission must decide whether some or all of the conditions have merit and whether, even with their imposition, the Transaction still has too much risk in return for too little reward.

XII. OVERALL RECOMMENDATION ON SECTION 1104

As stated in the Legal Standards Section earlier, before Verizon may abandon its properties and duties in Maine it must secure the Commission's approval. 35-A M.R.S.A. § 1104. In order to approve Verizon's Petition to Abandon, the Commission must ensure that the public interest is protected. *Id*. Thus, the Legislature granted the Commission authority to impose "terms, conditions or requirements as in its judgment are necessary to protect the public interest" and precluded the abandoning utility from objecting to any such conditions. *Id.* See, e.g., *Verizon New England, Inc. d/b/a Verizon Maine, Request for Waiver to Effect a Transfer of Subscribers*, Docket No. 2001-473, Order at 2, (July 25, 2001); *Edmund J. Quirion, Request to Abandon Service*, Docket No. 96-030, Order at 5 (Jan. 14, 1998).

While the Joint Applicants' Initial Filing requested that the Commission authorize Verizon to discontinue its ILEC regulated intrastate service in Maine as well as terminate its authority to provide such service, Verizon provided little, if any, testimony to address, let alone establish, that it had complied with the requirements of Section 1104. Application at 8-9. Indeed, none of the testimony filed by Verizon witnesses Smith and Morrison directly addressed the issue. *See* Smith Dir. and Reb, Morrison Reb. Further, Verizon's only statement in its brief on the topic can be found in a footnote which summarily states, in part, that, "[i]f the Commission concludes that the proposed transaction meets the no net harm test under Section 708, then the standards under Sections 1101 and 1104 also have been met because the Commission will have essentially determined that the proposed transfer and discontinuance of service are in the interests of ratepayers and the public." VZ Br. at 2, n. 2.

We find Verizon's lack of support for its abandonment request under Sections 1101 and 1104 both curious and troubling. Contrary to Verizon's assertions otherwise, the Commission could find that the Transaction meets other relevant statutory requirements but that it cannot make the necessary findings with regard to Sections 1101 and 1104 because Verizon has failed to present any evidence or argument that it has, in fact, met its burden. In our view, if the Legislature had intended that a finding under Section 708 would be sufficient for both approving the form of a transaction and the abandonment of service, it would not have enacted separate and distinct obligations under Section 1104 related to abandonment. Whether a potential deal meets the requirements of Section 708 is a separate question from whether, as a condition of abandonment, the Commission should impose conditions on the abandoning utility to address any pre-existing issues or contingencies.

This Report has identified a number of specific areas where we believe Verizon has failed to meet its abandonment burden. For example, in Section VI(B), we found that Verizon's decision to centralize, over time, the entirety of its back office system functions outside of Maine, and across its various regulated and non-regulated affiliates, placed upon Verizon a more stringent abandonment burden given that operational support systems which Maine ratepayers had paid for, in part, would no longer be available and new systems would need to be built and paid for by those same Maine ratepayers. Even though these issues were front and center throughout the proceeding, we can find nowhere that Verizon addresses them either factually or legally.

In section VII, we noted the significant deficiencies in Verizon's service quality over the term of the current AFOR. It is clear to us that Verizon made a business decision at some point during the past seven years that the costs associated with paying AFOR SQI penalties were less than the costs associated with addressing the root causes of its service quality problems, i.e., insufficient number of technicians, deteriorating outside plant, and/or overtime policies. Now, Verizon intends to abandon its Maine network and leave those long-brewing problems in the lap of FairPoint and the Commission who will be left to rectify them. We do not believe that type of "cut and run" approach complies with the legislative intent of Section 1104 or is in the public interest. Simply put, we do not believe the Commission should allow Verizon to abandon its Maine operations without committing the necessary funds to bring its service quality up to the minimum standards established in the current AFOR.

As has been discussed earlier in this Report (see Sections V(D), VI(B), and X), there are a number of specific conditions we recommend the Commission impose on Verizon in an effort to protect the public interest prior to Verizon's abandonment of its Maine operations pursuant to Section 1104. While these recommended conditions should rectify numerous issues we believe exist relative to Verizon's responsibilities under Section 1104, we believe the Commission should, even if it chooses to adopt those conditions, reach a finding that Verizon has failed to meet its burden of proving the public interest is met by its abandonment request.

As several parties have also suggested, we caution the Commission that it should not let its displeasure with Verizon's lack of cooperation and investment in Maine over the past five years influence the Commission's decision. The Commission should not succumb to the "anybody but Verizon" mentality that even Verizon, itself, seems to be encouraging. The Commission must make its decision based upon the evidence, or lack thereof, in the record of this proceeding.

XIII. CONCLUSION

For the reasons stated above, the Examiners' recommend that the Commission deny the Joint Applicants' Petition.

Respectfully submitted,

____

Trina M. Bragdon
Hearing Examiner

On behalf of the Advisory Staff:
Rich Kania
Derek Davidson
Rich Kivela
Joel Shifman
Phil Lindley
Paulina Collins
Michael Starkey
Warren Fischer

XIV. APPENDICES

APPENDIX 1

DETAILED DESCRIPTION OF TRANSACTION

The proposed Transaction involves the transfer of all ILEC operations and much (with some notable exceptions) of Verizon's other regulated and non-regulated business operations in Maine, New Hampshire and Vermont to FairPoint. In return, Verizon will receive consideration of approximately $1.7 billion, consisting of $900 million in a special cash dividend to be paid from FairPoint's cash at closing and approximately $800 million in Spinco debt securities, which Verizon New England (VNE) will exchange for other VNE debt. In addition, Verizon's shareholders will receive approximately $1.015 billion in FairPoint stock (over 54 million shares) in exchange for their shares of Spinco stock via a "spinoff" to be accomplished by Verizon concurrent with the remainder of the Transaction. It is important to note that Verizon has structured the transaction as a Reverse Morris Trust under IRS rules, resulting in all aspects the Transaction being treated as a tax-free event for Verizon, its subsidiaries and its shareholders.[93] The key aspects of the Transaction are discussed in more detail below.

2. <u>Assets, Liabilities and Employees</u>

Steven Smith, Verizon's Vice President of Business Development for the Company's Domestic Telecommunications group, described the mechanics of the Transaction and provided details about the assets, liabilities, customer relationships and contractual obligations that would be transferred from Verizon to FairPoint. Smith Dir.

[93] Except for a minimal amount of taxes that may be due on cash paid in lieu of partial shares of Spinco stock.

Test. at 3-11. He also described the assets and business arrangements that were not part of the Transaction and would be retained by various subsidiaries of Verizon Communications, most of which will continue to do business in the region. *Id*.

Verizon has established Spinco as the corporate entity that will become the holding company used to convey all of Verizon's regulated and certain non-regulated business activities in the NNE states to FairPoint in the Transaction. In addition, Verizon has established two subsidiaries (Telco and Newco) of Spinco that will be used to hold the parts of the NNE operations that will be transferred to FairPoint. VNE, which currently is the entity that provides local exchange, intrastate toll and exchange access services in all the New England states, will transfer the assets, liabilities and customer relationships for its operations in Maine, New Hampshire and Vermont to its new subsidiary, Northern New England Telephone Operations Inc. (Telco). NYNEX Long Distance, BACI and VSSI will transfer their customer relationships, accounts receivable and related service or contract obligations associated with long distance operations, Internet service operations and certain CPE maintenance operations in the three states to a wholly-owned subsidiary of Spinco called Enhanced Communications of Northern New England Inc. (Newco). VNE will transfer its stock in Telco to Spinco, with the result that Telco and Newco will be direct subsidiaries of Spinco. After a series of intermediate transfers, through which Spinco becomes directly owned by Verizon, Verizon will then distribute shares of Spinco directly to its shareholders, so that Spinco will no longer be owned by Verizon. Immediately following the distribution of Spinco stock to Verizon's shareholders, Spinco shares will be exchanged for shares of FairPoint under a predetermined formula, such that following the transaction, Verizon shareholders will, through the swap of Spinco shares, own approximately 60% of the outstanding shares of FairPoint.

As described by Verizon witness Smith, the Distribution Agreement contains a list of all VNE assets and liabilities related to local exchange, intrastate toll and exchange access operations that will be transferred to FairPoint. Smith Dir. Test. at 3-8. These operations are all regulated by the respective regulatory agency in each of the three NNE states. In addition to the fixed assets, contracts and other operating agreements, the Distribution Agreement includes goodwill as a going concern and other intangible properties, licenses and authorizations issued by governmental authorities. The liabilities to be transferred are those that arise from or relate to the assets and businesses of Telco, but they exclude certain tax, employee and debt obligations.

As described by Mr. Smith, the Distribution Agreement also lists the assets, liabilities and customer relationships that will be transferred to Newco, which will receive items related to the non-ILEC operations of Verizon in the NNE states that are being transferred to FairPoint. Smith Direct Test. at 6-8. Newco will receive assets, liabilities and customer relationships transferred from various Verizon affiliates, including NYNEX Long Distance Co. (NYNEX LD), Bell Atlantic Communications Inc. (BACI), Verizon Select Services Inc. (VSSI), Verizon Internet Services Inc., d/b/a Verizon On-Line, GTE.net LLC, and any Verizon subsidiary that employs a Spinco Employee, as that term is defined in the "Employee Matters Agreement." *Id.* After the Transaction is completed, Newco, under FairPoint's ownership and management, will control businesses that include: consumer and small business switched and certain dedicated long distance service to customers in NNE states, large business switched and dedicated long distance service currently offered by VSSI, delivery of dial-up, DSL and fiber to the premises data and dedicated Internet access services, CPE sales, installation and maintenance currently offered by VSSI, and private line service to current customers of VSSI where the line originates and terminates within the NNE states. *Id*.

Contracts and customer relationships associated with voice over Internet protocol (VOIP) service, prepaid card products, payphone dial around services and dedicated Internet access services of VSSI will not be transferred to FairPoint. Smith Direct Test. at 8. Also, aside from the customer relationships and related accounts receivable assets and service obligation liabilities, no other assets or business activities of NYNEX LD, BACI, VOL or GTE.net will be transferred to Spinco or ultimately to FairPoint. *Id*. Thus, these entities will remain active in the NNE states as affiliates of the Verizon Corporation.

Pursuant to the Distribution Agreement, the liabilities that will be transferred to Spinco and then to FairPoint include all liabilities relating to or arising from the Spinco Business, all liabilities relating to or arising from any Spinco assets, and all liabilities of the Spinco Business with respect to the Transferred Affiliate Arrangements, which are defined as all obligations and contract arrangements between VNE and other Verizon affiliates that relate to the Spinco Business. Smith Direct at 9. Most Affiliate Arrangements consist of contracts between VNE and the former MCI companies.

According to Mr. Smith, the Distribution Agreement also provides specifically that assets to be retained by Verizon and NOT transferred to Spinco will include the following:

(a) All intellectual property, except any that is specifically identified in the Merger Agreement;

(b) Certain assets such as Verizon's rights associated with the transaction, Verizon assets specifically excluded, such as pension assets retained by Verizon, defenses and counterclaims relating to any liability retained by Verizon, and the capital stock of each Verizon subsidiary;

(c) Any assets of Verizon Business Global LLC, which is the successor to MCI, Inc., and direct and indirect subsidiaries of Verizon Business Global LLC;

(d) Any assets of Verizon Network Integration Corp.;

(e) Any assets of Verizon Federal Inc.;

(f) Any assets of federal Network Systems LLC;

(g) Any assets of Verizon Global Networks Inc.;

(h) Any assets of VSSI, other than assets that constitute customer relationships or contracts that relate solely to Spinco Business;

(i) Any cash equivalents or short-term investments; and

(k) Any cash, except that required to satisfy the Target Working Capital amount, as defined in the Distribution Agreement.

Smith Direct at 10-11.

Verizon employees, who are defined as Spinco Employees in the Employee Matters Agreement, will be part of the Transaction and will continue their employment with Telco and Newco after the Transaction is completed. Thus, after all intermediate transactional steps are completed, they will become employees of FairPoint. Smith Direct Test. at 11-12. A Spinco Employee is an individual who is actively employed (full or part time) by, or is on a leave of absence or layoff with right of recall from, Verizon or a Verizon subsidiary whose primary duties at the time of closing of the Transaction were related to the Spinco Business and is not an employee otherwise determined to be retained by Verizon. *Id*. Shortly before the closing, Verizon and FairPoint will jointly finalize a list identifying all Spinco Employees by name. *Id*. Verizon will retain responsibility for the pension and health and welfare obligations of current Verizon retirees in the NNE states and of current employees in the three NNE states who retire prior to the closing. Verizon will also provide assets to FairPoint that will equal the present value of the accrued pension and other post-employment benefit obligations of the Spinco employees who are part of the transfer.

3. Purchase Price

FairPoint witness Michael Balhoff indicated that the price of the proposed Transaction would allow FairPoint to acquire Verizon's NNE lines at a relatively low nominal price per line, when compared to other recent deals. Tr. 10/04/07at 37 and 43-45. Under the proposed Transaction, FairPoint will pay Verizon approximately $1,803 per access line, based on the number of lines at the end of 2006. Tr. 10/04/07 at 43-45. In comparison, Verizon sold its Hawaiian Telephone property to the Carlyle Group, a private equity capital firm, for about $2,334 per access line, which some financial analysts considered to be a very low price at the time of the transaction. Mr. Balhoff also referenced purchases or spin-offs of telecommunications properties by Alltel and Century Tel., which were priced at $3,900 and $3,200 per line, respectively. Mr. Balhoff indicated that many analysts did not consider the Hawaiian Telecom sale to be comparable because of the special circumstances involved. Mr. Balhoff stated that he and other industry observers had never seen such a low price per line as the one presented in the proposed transaction. Tr. 10/04/07 at 43-45.

According to Mr. Balhoff, there are several reasons for the relatively low per line price of the proposed Transaction. Tr. 10/04/07 at 46-48. First, the use of the Reverse Morris Trust structure allowed both sides to agree to a price that is substantially lower than other similar transactions given the deal results in a zero- tax consequence for both Verizon and FairPoint, although FairPoint may lose some or all of its ability to use its net operating loss carry-forwards, which have built up in prior years. *Id*. In addition, the local exchange business has experienced a contraction in recent years, as competition from cable companies, wireless carriers, VOIP providers and traditional CLECs has somewhat eroded the ILEC business opportunities and made the rural ILEC operations less attractive to investors. *Id*. Finally, in Mr. Balhoff's opinion, Verizon has decided to strategically refocus its attention to businesses (specifically wireless and data businesses) that provide higher growth opportunities than are available in the wireline operations of the NNE states. *Id*.

The OPA disagrees with Mr. Balhoff's opinion that FairPoint is "getting a deal." For example, the OPA argues that the Alltel and Sprint Nextel spinoffs, both of which were tax-free transactions, exhibit major differences from the proposed Verizon/FairPoint Transaction and, thus, are not directly comparable on a price or other basis. OPA Br. at 50-52. The Alltel spinoff to Valor Communications, which subsequently was renamed Windstream Communications, also utilized the Reverse Morris Trust structure as a means of completing the transaction without the incurrence of tax liability. Sprint Nextel directly spun off its landline telephone operations to its stockholders, and the spun-off business was renamed Embarq Communications. The key difference asserted by the OPA is that in both the Windstream and Embarq transactions, the LEC operations that were spun off were fully functioning autonomous business units with intact and functioning back office systems. OPA Br. at 50-51. No new system implementation or development was needed in either case. Further, the management of each operating LEC was transferred substantially intact or the management of the acquiring entity was already in place. *Id.* Finally, according to OPA, the Debt to EBITDA ratio in each of these instances was substantially lower at the time of the transfer than that in the proposed Verizon/FairPoint transfer. OPA Br. at 52.

The OPA asserts that the primary driver in the lower price per line exhibited by the proposed Transaction in this proceeding is the use of the Reverse Morris Trust mechanism to complete the transaction. According to the OPA, if the transaction were not structured as a tax free transfer, the price per line would be closer to that seen in other transactions. OPA Br. at 46.

4. New Financing

In connection with the proposed Transaction, FairPoint has arranged debt commitments of approximately $2.88 billion. FairPoint will actually issue approximately $2.343 billion in debt instruments at the time of the closing, with another $200 million likely to be drawn down in the first year of operations. Smith Dir. At 13-16. The primary credit facility will be an 8-year secured Term Loan B with a commitment amount of $1.68 billion, of which FairPoint intends to use $1.543 billion at the time of closing of the Transaction. Id. Borrowing under Term Loan B will carry an interest rate of LIBOR (London interbank offered rate) plus **BEGIN CONFIDENTIAL** _____ **END CONFIDENTIAL**. Labor Exh. 5 (Confidential). Of the total Term Loan B amount borrowed, $900 million, which equals the approximate tax basis of the Verizon assets being transferred to FairPoint, will be used to pay a special dividend to Verizon. The remaining $643 million will be used to refinance FairPoint's currently outstanding debt and to pay debt issuance costs. Smith Dir. Test at 15-16.

FairPoint will also have access under the new credit commitment to a 6-year non-amortizing revolving credit facility (hereafter "Revolver") of up to $200 million, which will carry an interest rate of LIBOR plus **BEGIN CONFIDENTIAL** ____ **END CONFIDENTIAL**. However, it is important to note that the actual interest rate to be paid by FairPoint is subject to change based on FairPoint's financial condition at the end of the first quarter after closing. Labor Ex. 5 (Confidential) and OPA 115 (Company's S-4/A, which is not confidential). FairPoint has indicated that it does not have current plans to make any draws under the Revolver, but is the funds are nonetheless available as a cushion for any additional cash needs that may arise. FairPoint will pay a commitment fee equal to 0.375% per annum on the average daily unused amount of the Revolver, payable quarterly. Any amounts borrowed and repaid under the Revolver are available for re-borrowing during the term of the Revolver. Id. Finally, the credit agreement contains a delayed draw term loan facility in the amount of $200 million, which FairPoint can utilize during the first year after closing, and which must be repaid in full by the eighth anniversary of the closing. The delayed draw loan has an interest rate of LIBOR plus **BEGIN CONFIDENTIAL** ____ **END CONFIDENTIAL**. Labor Exh. 5 (Confidential). It is anticipated that FairPoint will make use of the full amount of the delayed draw loan to pay for system conversion costs, one-time operating expenses associated with the conversion and to augment its cash balances.

The primary banks involved in the new credit facility are Lehman Brothers Inc., Bank of America (and its affiliate Banc of America Securities LLC), and Morgan Stanley, with Lehman designated as Administrative Agent and Bank of America acting as the sole syndication agent. OPA 115. Each of the primary banks has agreed to assume a certain percentage of the total loan commitment, and each of the primary banks may syndicate or otherwise assign a portion of its commitment to other banks or institutions that wish to participate in the facility. *Id*.

The new credit facility will require that FairPoint's existing and subsequently acquired subsidiaries serve as guarantors of the new credit facility, unless such a guarantee would require approval of a state regulatory agency. The new credit facility, guaranties, hedging arrangements and cash management obligations will be secured by a first priority security interest in all capital stock and other equity interests of the combined company or any guarantor's domestic subsidiaries and any intercompany indebtedness. Labor Exhibit 5 (Confidential) (made public in OPA Ex. 115 at 134-135).

Under the new credit facility, the combined company will be required to meet certain financial tests, including a minimum cash interest coverage ratio, as measured by Earnings Before Interest Taxes Depreciation and Amortization (EBITDA) to Interest Expense, of 2.25 to 1 and a maximum total leverage ratio (total indebtedness to EBITDA) not to exceed 5.75 to 1 during the first year after closing, and 5.50 to 1 thereafter. These covenants will be tested on a combined company basis quarterly beginning with the first full quarter following the close of the transaction. Other covenants will limit the combined company's ability to incur additional indebtedness or participate in mergers, consolidations, liquidations and dissolutions and asset sales. OPA 115.

Except for the first two quarters following the merger, FairPoint's ability to pay dividends at its current rate might be restricted under the terms of the credit agreement. As long as FairPoint is not in default, it will be permitted to pay up to $80 million in dividends during the first two quarters following the Transaction. After that the total amount of quarterly dividends may not exceed EBITDA plus $40 million minus the product of 1.4 times FairPoint's consolidated interest expense, including that of all subsidiaries. Also following the first two quarters, the company may not pay dividends if its total leverage ratio exceeds 5.75 to 1 during the first full year after the closing date and 5.50 to 1 after the first year. OPA Ex. 115.

In addition to the term bank loan, Spinco will issue approximately $800 million in senior, 10-year unsecured notes to Verizon. In FairPoint's financial model, the bonds are assumed to carry a fixed rate of **BEGIN CONFIDENTIAL** _____ **END CONFIDENTIAL**, although the interest rate will not be set until the loan agreement is finalized, and the notes will be used by VNE to accomplish a debt for debt exchange with some of VNE's currently outstanding debt. FairPoint may not call these notes for early redemption during the first five years after they are issued. Verizon has the right to exchange the Spinco securities for debt of VNE that is held by third-party creditors. The exchange would be facilitated through an unaffiliated third party that would acquire from creditors of VNE debts owed by VNE in the approximate amount of the Spinco securities. The intermediary would then exchange the acquired debt in return for the Spinco securities. Thereafter, the intermediary would re-market those securities. Smith

Dir. Test. at 15-16. The Spinco securities are expected to contain covenants and restrictions that are similar to those contained in loan agreements of comparable risk, although the final terms of the securities apparently have not been finalized and will not be completed until just prior to the closing. OPA Ex. 115.

FairPoint has indicated that the interest rate on a portion of the Term Loan B is expected to be fixed through the use of interest rate swap agreements. FairPoint estimates that $550 million will be fixed at the time of closing at a blended rate assumed to be 6.3%, with additional swap arrangements possible in the future. Leach Reb. Test. at 32-33.

5. FairPoint Stock to be Issued

In order to complete this Transaction as a tax-free event under the provisions of the IRS rules and regulations, FairPoint will issue approximately $1.015 billion of its stock to Spinco (current Verizon) shareholders at the time of the closing. Smith Dir. Test at 15-16. The mechanics of the stock portion of the Transaction are that Verizon will distribute the shares of its Spinco subsidiary to its shareholders immediately prior to closing. Verizon shareholders will receive one share of Spinco stock for each Verizon share they own, and immediately after the closing, each Spinco shareholder will exchange their Spinco shares for shares of FairPoint common stock. *Id*. The exchange ratio will be one share of new FairPoint stock for each 55 shares of Spinco stock. Therefore, FairPoint will issue slightly over 54 million new shares of stock to Verizon shareholders. *Id*.

After the Transaction is consummated, FairPoint will have slightly over 89 million shares outstanding. Mr. Smith asserts that the exchange ratio was determined though arms length negotiations between the companies, taking into consideration the value of the Spinco assets and operating businesses being transferred and the relative market valuations of the stock of each company at the time of the Merger Agreement. Smith Dir. Test. at 16. FairPoint shareholders voted to approve the Transaction at their Annual Meeting in August, while Verizon shareholders are not required to vote on it, in accordance with applicable security laws and Verizon's corporate bylaws.

As a result of the Transaction, FairPoint will be the surviving corporation, but the former Verizon shareholders will own approximately 60% of the outstanding FairPoint shares post-merger. Smith Dir. Test. at 17. As part of the Merger Agreement, Verizon will nominate six of the nine members of the new FairPoint Board of Directors. None of the Verizon nominees may be employees of Verizon, Verizon Wireless or other affiliates. Therefore, Verizon will have no control over the operations, management or corporate governance of FairPoint after the Transaction, although it will nominate a super-majority of the initial FairPoint post merger Board. *Id.* at 18. Verizon has already announced one of its nominations, which received approval from FairPoint's Board of Directors at the Company's Annual Meeting.

6. Reverse Morris Trust

Verizon proposed the use of the Reverse Morris Trust (RMT) structure for the Transaction in order to allow it to go forward as a tax free exchange to Verizon, its subsidiaries and its shareholders. Smith Dir. Test. at 16-17. In previous sections, the basic mechanics of the various segments of the transfer have been described in connection with the terms of the Transaction. To qualify for tax-free status under the RMT, Verizon shareholders must own more than 50% (but less than 80%) of the outstanding shares of the post merger surviving corporation. Verizon and FairPoint agreed that Verizon shareholders would own approximately 60% of the outstanding FairPoint shares immediately following the closing of the Transaction. *Id*. at 17. The payment of a special dividend by FairPoint (not to exceed the tax basis of the Verizon assets being transferred, which equates to about $900 million) and the issuance of notes by Spinco to VNE, which VNE can use in a debt for debt exchange, were also aspects of the Transaction that required IRS approval. Verizon requested an opinion about the tax status of the Transaction, and the IRS recently confirmed that the use of the RMT method with the proposed Transaction specific provisions would qualify the proposed Transaction as a tax-free reorganization. Verizon will use its preferred scenario, identified as Alternative 2, of exchanging VNE debt for the Spinco securities. Supp. Resp. to Labor Gr. I; 1-31.

Appendix 2

Advisory Staff Recommended Service Quality Index From Docket No. 2005-155

1. Duration. The SQI proposed by staff should begin at closing and extend thereon for a period of five years. After this period, the Commission can determine if it is necessary to extend the SQI.

2. Penalty-Rebate Mechanism. The penalty-rebate mechanism will use "service compensation points" where one point is equal to 1% over the benchmark performance standard. Each metric will be measured separately, as is presently the case, and the service compensation points will be totaled for a final score. However, higher amounts of points will incur a progressively greater amount of penalty *per point*, as shown in Table 4. Therefore, as FairPoint's performance worsens, the rebate it must pay customers increases more than proportionally. For example, if the total of each metric's percentage over benchmark is 80, FairPoint would incur a total customer rebate obligation of $1,475,000 ($375,000 for the first 25 points plus $1,100,000 for the next 55 points).

Table 4: Penalty-Rebate Structure

Points Over Baseline	Rebate Dollars per Point	Maximum Rebate
0 to 25	$15,000	$375,000
26 to 100	$20,000	$1,875,000
101 to 150	$25,000	$3,125,000
151 to 200	$35,000	$4,875,000
201 to 250	$50,000	$7,375,000
251 to 300	$75,000	$11,125,000

In addition, if FairPoint's annual performance is worse than a metric's baseline in two or more consecutive years, FairPoint will pay an additional customer rebate amount. The additional penalty-rebate will be calculated by multiplying the base rebate for the metric by the number of years FairPoint missed the baseline (multiply by 2 for the second consecutive year FairPoint missed the baseline, by 3 for the third consecutive year FairPoint missed the baseline, etc.).[94]

The penalty-rebate, if any, shall be paid to customers in December. FairPoint shall place on customer bills containing service quality rebates the notation "REBATE FOR BELOW-STANDARD SERVICE QUALITY" next to the rebate amount. If the annual penalty-rebate exceeds $750,000, FairPoint shall provide the rebates to customers in equal credits in 12 monthly bills. In years where a penalty-rebate must be paid, FairPoint shall submit a report of the rebate calculation to the Commission.

3. The Revised Metrics. We will retain 13 of the metrics from Verizon's SQI established under the Second AFOR. The benchmarks for these metrics will remain unchanged. We will also add a new "Duration of Residential Outages" metric.

Metric	Benchmark
Customer Service	
Premise Installations (% Appts Not Met Company Reasons) Percent of customer initiated service orders, where a premise visit is required, for installation of local exchange service with specific commitment dates not kept as scheduled for Company reasons.	12.64%

[94] There is no cap amount for individual metric penalties, or total cumulative metric penalties.

Mechanized Installations (% Appts Not Met Company Reasons) Percent of customer initiated service orders, where a premise visit is not required, for installation of local exchange service with specific commitment dates not kept as scheduled for Company reasons.	0.10%
Premise Repairs (% Appts Not Met Company Reasons) Percent of customer initiated service orders, where a premise visit is required, for repair of local exchange service with specific commitment dates not kept as scheduled for Company reasons.	16.11%
Mechanized Repairs (% Appts Not Met Company Reasons) Percent of customer initiated service orders, where a premise visit is not required, for repair of local exchange service with specific commitment dates not kept as scheduled for Company reasons.	7.21%
Held Orders (Average Total Delay Days) The number of "delay days" between customers' promised installation dates and the dates the installations are actually completed, averaged over all customers with orders delayed for Company reasons.	6.21
Business Office Calls (% Answered Over 20 Seconds) The percent of customer calls to the business office not answered by a live representative within 20 seconds.	31.00%
Repair Service Calls (% Answered Over 20 Seconds) The percent of customer repair calls not answered by a live representative within 20 seconds.	23.10%
Service Reliability	
Customer Trouble Reports (Rate per 100 Lines – Network) The number of customer trouble reports to FairPoint repair centers divided by the number of customer lines (expressed in hundreds of lines).	1.08
Repeat Trouble Reports (Rate per 100 lines) Recurring service problems reported by customers within 30 days of their initial trouble report, as a rate per 100 lines.	0.12

% Troubles Not Cleared (Within 24 Hrs. – Residence) Percentage of residential customer trouble reports not resolved within 24 hours from the time the initial report was received. This standard includes subsequent reports on the same trouble and those troubles where access to the customer's premises is required by not available.	21.10%
% Troubles Not Cleared (Within 24 Hrs. – Business) Percentage of business customer trouble reports not resolved within 24 hours from the time the initial report was received. This standard includes subsequent reports on the same trouble and those troubles where access to the customer's premises is required by not available.	9.00%
Major Service Outages Results of a formula that takes into account the magnitude of the outage (higher weight given to outages affecting more customers); the duration of the outage (higher weight given to lengthy outages); and the services affected (higher weight given to local and emergency services).	614
Duration of Residential Outages The average number of hours between the time a residential trouble report is received by FairPoint and the time the trouble report is cleared for both initial out-of-service and repeat out-of-service intervals. (Based on FCC ARMIS Report 43-05.)	17.5
PUC Complaint Ratio The number of complaints filed with the CAD against FairPoint per 1,000 customers.	0.52

4. Reporting. FairPoint shall file monthly reports of its performance under the SQI using the Commission's electronic filing system. (Diskettes containing the monthly reports in Excel format no longer need to be submitted.) Monthly reports are due by the 15th of the month following the month being reported (e.g., the report of July's performance is due by August 15, etc.). FairPoint shall file its annual SQI reports by August 1st of each year, and shall file reports of its annual penalty-rebate amount, if any, by October 1st of each year. The annual penalty-rebate report shall include the amount to be credited to each customer, and contain the calculations used to determine the amount of the individual customer credit.

APPENDIX 3

SUMMARY OF RECOMMENDED CONDITIONS

Financial and Transactional Issues

V-D-1	Require the transaction to be restructured to reduce FairPoint's bond debt by $600 million.
V-D-2	Require FairPoint to immediately reduce the dividends it pays to its shareholders by $42 million.
V-D-3	Require FairPoint to file the "near final" loan agreements for Commission review and approval prior to closing with the Commission reserving the right to impose additional mitigating conditions if the terms materially change.
V-D-4	Require FairPoint to provide detailed quarterly and annual financial results as well as copies of all financial filings made with the FCC and SEC.
V-D-5	Establish a specific annual report form for FairPoint.
V-D-6	Allow FairPoint to temporarily adopt Verizon's CAM conditioned on FairPoint filing with the Commission within one month of closing a report that provides a detailed description of how the Verizon CAM will be used specifically by FairPoint in allocating costs.
V-D-7	Require FairPoint, as part of its annual report, to include a spreadsheet, chart or other form that shows all revenues and charges to or from its regulated ILEC operations in Maine to any affiliated interest.
V-D-8	Prohibits FairPoint from recovering an acquisition premium or transaction costs from Maine ratepayers and make clear the appropriate capital structure for rate making purposes will be determined in any future rate case involving FairPoint's Maine operations.

Wholesale Issues

VI-A-1	Consider FairPoint to be a successor and assign of Verizon and, therefore, subject to the requirements of section 271 as well as all other obligations applicable to BOCs.
VI-A-2	Require FairPoint, upon request, to extend all the terms of its interconnection agreements by at least two years.
VI-A-3	Require FairPoint to file an updated version of Verizon's wholesale tariff within a year of closing.
VI-A-4	Require FairPoint to abide by section 251 and impose a three-year freeze on section 251 UNE rates.

VI-A-5	Prohibit FairPoint from seeking either a section 251(f)(1) or 251(f)(2) exemption.
VI-A-6	Require FairPoint to provide access to unbundled switching, DS3 local loops in Portland, DS3 and dark fiber transport between Portland and Bangor as well as any future loops and transport/dark fiber routes that attain non-impaired status under section 251.
VI-A-7	Require FairPoint to abide by the terms of the District Court's Remand Proceeding as it relates to line sharing and dark fiber loops.
VI-A-8	Require FairPoint to file copies of any agreements which create ongoing obligations pertaining to "resale, number portability, dialing parity, access to rights-of-way, reciprocal compensation, interconnection, unbundled network elements or collocations" with the Commission for a period of at least three years.
VI-A-9	Require FairPoint to participate in, and abide by, the Commission's Rapid Response Process, which includes jurisdiction over any operational disputes involving section 271 UNEs.
VI-A-10	Require FairPoint to abide by the terms of Verizon's PAP until FairPoint and the CLECs develop a more simplified PAP.
VI-A-11	Require FairPoint to freeze access rates for three years.
VI-A-12	Require both FairPoint and Verizon to pro-rate any volume commitments related to wholesale services.
VI-A-13	Prohibit FairPoint from counting MCI fiber-based collocations for impairment purposes under section 251 for a period of three years.
VI-A-14	Require FairPoint to file a monthly status report regarding progress in putting together the Pole Licensing and Administration Group and set April 1, 2007 as the deadline for FairPoint to be ready to assume pole licensing and administration duties.
VI-A-15	Require FairPoint to refrain from filing petitions for forbearance with the FCC for a period of three years.

Back Office Systems

VI-B-1	Require Verizon to offer its TSA services to FairPoint at a price equal to \$0 per month for 6 months, if necessary, after closing. If after six months FairPoint still requires use of the TSA services, then Verizon will be allowed to begin charging fees consistent with those currently included in Schedules A-D of the TSA.
VI-B-2	Require FairPoint, as a condition of approval, to fulfill its commitment related to a third-party monitor, i.e., to fund and cooperate as necessary to allow the consultant to fulfill in a meaningful way, the Scope of Work identified in Advisors Exhibit 338.
VI-B-3	Retain the right to suspend and investigate FairPoint's readiness for cutover based upon material defects or deficiencies identified by the consultants or comments received by the parties.

VI-B-4	Require FairPoint to compensate CLECs, if a CLEC brings and successfully defends its claim, for unreasonable costs in moving from the Verizon to the FairPoint systems.
VI-B-5	Prohibit FairPoint from charging its CLEC customers for training that is specific to understanding or interacting with its new systems and interfaces for a period of six months after cutover.

Broadband

VI-C-1	Require FairPoint to increase the investment currently committed to its broadband expansion plan, from $17.55 million, to $28 million.
VI-C-2	Require FairPoint to focus the additional investment ($10.45 million) in rural areas, preferably unserved by other broadband delivery technologies
VI-C-3	Require Verizon, as a condition of its request for abandonment, to pay the entirety of the $12 million in additional broadband investment it agreed to make in Docket No. 2005-155, without seeking, or receiving, reimbursement, either directly or indirectly, from FairPoint.
VI-C-4	Forbid FairPoint from compensating Verizon, either directly or indirectly, for the $12 million in DSL investments related to Docket No. 2005-155.
VI-C-3	Require FairPoint to price its broadband-related services at statewide rates, without differences between urban, suburban or rural wire centers. All promotional and standard offerings should be available to all of FairPoint's Maine-based customers at the same prices, terms and conditions.
VI-C-4	For a period of at least three years from closing, FairPoint will provide all DSL-related services from a subsidiary separate and apart from the regulated telephone enterprise. The separate subsidiary will purchase all DSL-related functionalities from the regulated utility at a rate equal to **BEGIN SUPER COMPETIVIELY CONFIDENTIAL** _____ **END SUPER COMPETITIVELY CONFIDENTIAL** per line, per month. To the extent that FairPoint, at any time during this period, believes that the "transfer rate" identified above should be adjusted, based upon changes in cost incurred by the regulated enterprise in providing the necessary functionality, FairPoint may petition the Commission to review the rate and if necessary, approve a different rate. The Commission may, at its discretion, extend the period within which FairPoint is required to maintain this arrangement for one additional 3-year period.

VI-C-5	For a period of at least three years from closing, FairPoint will provide, where it has the facilities to do so, its DSL products on a stand-alone basis. Specifically, FairPoint will not include requirements that consumers also purchase its telecommunications services or any other services it offers as a condition of purchasing DSL services. During this period, FairPoint's stand-alone DSL service will not exceed the effective transfer price described above, plus 25%. The Commission may, at its discretion, extend the period within which FairPoint is required to maintain this arrangement for one additional 3-year period.

Service Quality

VIII-1	Require Verizon to grant FairPoint permission to hire former Verizon employees without any waiting period.
VIII-2	Require Verizon to continue to provide services pursuant to the TSA at a reduced cost beyond the six month no cost period recommended in the Back Office Systems Section above (Section VII(C)) until such time that FairPoint can hire employees to replace the employees who choose to retire.
VIII-3	Require FairPoint to develop a plan to address the potential loss of experienced workers.
VIII-4	Require Verizon/FairPoint to submit a monthly report depicting key call center statistics beginning immediately after the close as well as require Verizon to continue answering customer calls at no cost after the six month TSA period if Verizon fails to meet the call center metrics contained in the staff recommended SQI during the six month TSA period. Verizon should continue to answer customer calls on FairPoint's behalf until such time as it complies with the call center metrics for at least three consecutive months.
VIII-5	Require FairPoint to comply with the Recommended SQI from Docket No. 2005-155.
VIII-6	Require FairPoint to meet the specific commitments it has made regarding hiring additional staff, refurbishing wire centers, and prioritizing repair dispatches.
VIII-7	If the Commission does not accept OPA's recommendation to reduce the sales price by $600 million, require Verizon to place funds in an escrow account sufficient to cover the cost of completing the necessary wire center refurbishments.
VIII-8	If the Commission decides an SQI is not necessary as a condition, require Verizon to improve its performance regarding the "Repair Reports Not Cleared in 24 Hours – Residential" service quality metric through the creation of the escrow account referenced above.

Federal Regulatory

XIII-1	Require FairPoint to obtain a waiver of the FCC's price cap rules before the Transaction closes.
XIII-2	Prohibit FairPoint from increasing its access rates, including special access rates or SLC rates, above those currently allowed for Verizon for four years - even if FairPoint is required to file its own rates.
XIII-3	Encourage FairPoint to lobby the FCC for changes to the rural support mechanism and the high-cost benchmark.

ETC Status

XI -1	As a condition of being granted ETC status, FairPoint must: 1) provide the nine services supported by the USF that are required of ETCs; 2) advertise the availability of, and prices for, such services; 3) offer Lifeline and Link-Up to customers and 4) use the USF funds it receives in compliance with 47 U.S.C. § 254(e).

Privacy Policy

X-1	Require Verizon to continue to be subject to the Commission's jurisdiction for purposes of the existing claims in the *NSA Proceeding*. In the alternative, require Verizon to indemnify FairPoint for any penalties that the Commission might impose if the *NSA Proceeding.*
X-2	Require FairPoint to review its privacy policy and practices to specifically consider whether changes may be necessary and report back to the Commission in six months.

APPENDIX 4

ABBREVIATIONS AND ACRONYMS

6-Year Non-Amortizing Revolving Credit Facility	"Revolver" or "Credit Facility"
Adjusted Earnings Before Interest and Taxes	Adjusted EBIT
American Association of Retired Persons	AARP
Agreement and Plan of Merger	Merger Agreement
Alternative Form of Regulation	AFOR
Asynchronous Transfer Mode	ATM
Bell Atlantic Communications Inc.	BACI
Biddeford Internet Corporation d/b/a Great Works Internet	GWI
Cost Allocation Manual	CAM
Capital Expenditures	CAPEX
Communication Workers of America	CWA
Competitive Local Exchange Carrier	CLEC
Cost Allocation Manual	CAM
CLEC Coalition Brief	CC Br.
Compounded Annual Growth Rate	CAGR
Customer Premise Equipment	CPE
Customer Proprietary Network Information	CPNI
Digital Loop Carrier	DLC
Digital Subscriber Line Services	DSL
Direct Broadcast Satellite	DBS
Dual Tone Multifrequency	DTMF
Earnings Before Interest, Taxes, Depreciation, and Amortization	EBITDA
Eastern Maine Labor Council	Council
Eligible Telecommunications Carrier	ETC
Enhanced Communications of New England, Inc.	Newco
FairPoint Brief	FP Br.
FairPoint Projection Model	Discovery Model
Fiber-to-the Home	FTTH
Federal Communications Commission	FCC
GTE.net LLC	GTE.net
Internet Protocol Television	IPTV
Independent Telephone Company	ITC
Incumbent Local Exchange Carrier	ILEC
Interexchange carrier	IXC

Internal Revenue Service	IRS
Initial Projection Model	"Leach/Balhoff" or "Testimony" Model
Initial Public Offering	IPO
Local Exchange Carrier	LEC
Joint Application	JA
Lehman MAC Model	MAC Case Model
Lehman New Base Case Model	FairPoint Board Model
London Interbank Offered Rate	LIBOR
Maine's telecommunications stakeholders	consumers, competitors, other telecommunications providers
Maine Civil Liberties Union	MCLU
Maine Universal Service Fund	MUSF
Metropolitan Statistical Area	MSA
Multi-Service Access Nodes	MSAN
Internet Protocol/Multi-Protocol Label Switching	IP/MPLS
National Security Agency	NSA
New Hampshire Public Utilities Commission	NH PUC
Northern New England	NNE
Northern New England Spinco Inc.	Spinco
Northern New England telephone Operations, Inc.	Telco
Northland Telephone Company of Maine, Inc., Sidney Telephone Company, Standish Telephone Company, China Telephone Company, Maine Telephone Company, and Community Service Telephone Co.	FairPoint Classic
New England Telephone and Telegraph Company	NYNEX
National Security Agency	NSA
NYNEX Long Distance Co.	NYNEX LD
Office of the Public Advocate	OPA
One Communications	One
Operational Support Systems	OSS
Oral Data Request	ODR
Plain Old Telephone Service	POTS
Performance Assurance Plan	PAP
Regional Bell Operating Company	RBOC or BOC
Reverse Morris Trust	RMT
Securities and Exchange Commission Form S-4 (Amended Version)	S-4/A filing
Rural Local Exchange Carrier	RLEC
Return on Equity	ROE

Securities Exchange Commission	SEC
Service Quality Index	SQI
Support Services Agreement	SSA
Telephone Association of Maine	TAM
Total Element Long Run Incremental Cost	TELRIC
Time-division multiplexed	TDM
Transaction Services Agreement	TSA
Triennial Review Order	TRO
Triennial Review Remand Order	TRRO
Transcript	Tr.
Universal Service Fund	USF
Unbundled Network Elements	UNE
Unbundled Network Element Loop	UNE-L
Unbundled Network Element Platform	UNE-P
Verizon New England Inc./Verizon Communications, Inc.	Verizon
Verizon's Fiber to the Home Offering	FIOS
Verizon Internet Services Inc., d/b/a Verizon On-Line	VOL
Verizon Select Services Inc.	VSSI
Vermont Public Service Board	VT PSB
Voice Over Internet Protocol	VOIP
Weighted Average Cost of Capital	WACC