

I. INTRODUCTION

The Public Advocate recommends that the transaction, as proposed, be rejected, because the potential adverse impacts lead to a finding that this reorganization is not consistent with the interests of ratepayers pursuant to *35-A M.R.S.A. Section 708*. However, at the same time, the Public Advocate believes that the transaction is salvageable. After the end of the hearings, the Public Advocate identified 24 conditions that would, if adopted, result in a transaction that would, on balance, be consistent with the interests of ratepayers and shareholders¹. If all of these conditions were to be imposed, the Public Advocate would recommend that the Maine Public Utilities Commission (“the Commission”) approve the transaction.²

At its core, this case is about adverse impacts that may result from the transaction proposed by the Joint Petitioners. In the face of the adverse impacts the Commission has three choices: (A) it may approve the petition subject to conditions designed to prevent adverse impacts, (B) it may find that the adverse impacts are outweighed by certain direct benefits of the transaction and hence approve the Joint Petition, or (C) it may reject the Joint Petition.

If the transaction is approved without the imposition of many stringent conditions, the financial weakness of FairPoint would expose nearly all the state’s telecommunications ratepayers to significant risk of receiving service from a distressed utility. Verizon serves 87%

¹ In this case, the shareholders of Verizon and the shareholders of FairPoint have competing interests. Some of the Public Advocate’s conditions would represent a benefit to the shareholders of FairPoint if the transaction is approved. Moreover, the commonality of interests between Verizon and FairPoint shareholders as alleged by Joint Petitioners would diverge instantaneously with the closing of the transaction. Some Verizon shareholders then owning “new” shares of FairPoint, particularly institutional shareholders (e.g, mutual funds) would immediately begin selling since they are precluded from holding risky stocks such as FairPoint. Since Verizon merely seeks to abandon service in this proceeding, for purposes of Section 708, the Commission should focus on the ratepayers and shareholders of the surviving utility, i.e., those of FairPoint.

² Each recommended condition is listed and discussed below

of the households in the NNE region.³ As a “high debt/high dividend” LEC, FairPoint would be in a very poor position to deal with any significant adversity.

FairPoint is proposing to start up its new NNE entity at a time when it is facing the prospect of flat or declining revenues. For companies like FairPoint, the growth prospects for their core business are minimal at best. If FairPoint’s projections overestimate their revenues, if their revenues are lower than projected, and if their expenses come in higher than expected, then FairPoint would be required to adjust its business strategy, but it would have to do so from a weak financial platform. As further addressed below, FairPoint’s financial condition entering into the transaction is very weak and its projections regarding its financial condition going forward are overly optimistic. FairPoint’s financial model contains data that is not verifiable, and assumptions that are flawed. In short, the Commission should not rely on FairPoint’s financial projections to support a finding that the proposed new company would be financially viable.

Adverse consequences arising from the weak financial platform of FairPoint must be addressed by conditions that require restructuring of the agreements between Verizon and FairPoint. Absent that restructuring, FairPoint would likely have to choose among a series of deleterious actions, such as raising its telephone rates, permitting service to deteriorate, reducing annual amounts of investment, squeezing its employees’ compensation, or cutting dividends. Facing distress, FairPoint would most likely choose a combination of these actions. These actions, singly, or in combination, are additional adverse impacts that must be addressed by conditions that would require FairPoint to adopt policies that are consistent with the interests of ratepayers.

On cross-examination, FairPoint witness Skrivan concurred that FairPoint does not challenge the Commission’s authority to order any conditions in this proceeding. *TR at 228.*⁴

³ Brevitz Direct, page 18.

greater of 25% or the amount of capital expenditure increment under the projections;

- If the Commission does not require FairPoint to limit its proposed debt leverage at inception, then, in any year beyond 2008 in which unadjusted net Debt/EBITDA is greater than 4.5x, 50% dividend reduction shall be required with the proceeds deployed to pay down debt; and,
 - If the Commission does require FairPoint to limit its proposed debt leverage at inception as recommended by the Public Advocate, then, in any year beyond 2008, there shall be a 25% dividend reduction in any year in which unadjusted net Debt/EBITDA is greater than 4.0x, with the proceeds deployed to pay down debt.
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
 4. The Commission should review and approve final debt agreements.
 5. Service groups covered by the TSA must be unbundled, along with associated cost-based charges, so that TSA services can be transitioned independently with an associated reduction of TSA charges to FairPoint.
 6. Verizon must ensure that all of FairPoint's new back office systems, including billing and customer service systems, are fully functional before Verizon is permitted to abandon service. At four months after closing, all TSA payments will cease and Verizon will continue to provide all necessary services under the TSA until successful cutover of the unbundled function.
 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.
 8. FairPoint must agree to meet the current and amended service quality performance standards set forth in Public Advocate's testimony applicable to the Verizon operations, be subject to the proposed revised penalty structure, agree to standards that would make sure that current service quality performance for its Maine "classic" companies will not deteriorate, and submit a combined service-quality performance plan with associated penalties similar to the one currently in effect for Verizon when it combines the operations of the former Verizon and its "classic" companies in the future.

9. Verizon must pay 50% of capital expenditures necessary to bring plant facilities to levels that remediate service quality problems under the standards for service quality required by the Commission. An escrow fund shall be created for this purpose to be administered by the Commission.
10. FairPoint must provide monthly reports to the Commission beginning immediately to provide the staffing status for FairPoint's northern New England service area, with particular emphasis on adequacy of technical skills for workers being placed in new positions due to any significant departure of experienced staff in the period six months before, to six months after, close of the transaction. The report shall include training plans and progress associated with bringing workers in new technical positions up to adequate skill levels.
11. FairPoint must increase high-speed Internet (DSL) availability to 90% of access lines, under the detailed and enforceable plan recommended by the Public Advocate.
12. FairPoint's DSL prices should be no higher, and its DSL speed should be no lower, than the comparable service provided by Verizon during the previous year. Such pricing and speed comparisons shall include Verizon's long-term promotional offers, including its online offer of \$15 per month for life at 768 Kbs.
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.

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 # 2005-155
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
16. FairPoint must offer competitive local phone companies all of the wholesale services that Verizon was obligated to provide, including Section 271 obligations and obligations of Bell operating companies.
17. FairPoint should offer standalone DSL service at a reasonable price (under \$25), to those customers who do not want FairPoint’s local telephone service
18. The Commission should retain jurisdiction over Verizon-Maine for the purpose of completing its investigation and applying any remedy, in connection with the Cowie complaint, at such time that the case is remanded to the Commission or the stay of the federal district court is lifted.
19. FairPoint shall request, and Verizon will support, a waiver of the “parent trap” rule in order to seek rural high-cost support for FairPoint’s northern New England operations if the Commission determines that increases support may be available. If the waiver is approved, rates will be decreased to the extent of any additional USF support.
20. FairPoint shall not seek to increase the SLC charge to residential or business customers above the current rates of Verizon, before 2012
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.
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.

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.
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.

II. STANDARD OF REVIEW

The “reorganization” statute (35-A MRSA § 708) states that the Commission cannot approve a proposed reorganization unless the applicant for approval establishes “that the reorganization is *consistent with the interests* of the utility’s ratepayers and investors.”⁵ (emphasis added).

In prior reorganization cases, the Commission has construed the “consistent-with-the-interests” language of the reorganization statute as articulating a simple “no harm” standard.⁶ That is, the Commission has “approved reorganizations where the merging parties have established that the transaction will not adversely affect ratepayers and investors.”⁷

⁵ The pertinent portion of 35-A M.R.S.A. §708(2) reads as follows:

2. **Reorganization subject to commission approval.** Reorganization shall be subject to commission approval as follows:

- A. Unless exempted by rule or order of the commission, no reorganization may take place without the approval of the commission. No reorganization may be approved by the commission unless it is established by the applicant for approval that the reorganization is consistent with the interests of the utility’s ratepayers and investors...

⁶ Verizon Communications, Inc., and MCI, Inc., Request for Approval of Reorganization and Approval of Agreement of Verizon Communications, Inc. and MCI, Inc., Request for Approval of Reorganization and Approval of Agreement of Verizon Communications, Inc., and MCI, Inc., Docket No. 2005-154, Order, Part II, p. 3 (MPUC Dec. 22, 2005). (hereinafter, Verizon/MCI Order)

⁷ Id. The Commission also sites to two of its more recent “reorganization” orders: *See New England Telephone Co., Re: Joint Petition of New England Telephone Company and NYNEX Corporation for Approval of the Proposed Merger of Wholly-Owned Subsidiary of Bell Atlantic Corporation into NYNEX Corporation, Docket No. 96-388,*

We suggest that the “consistent-with-the-interests” standard requires further definition. First, when considering reorganization, the Commission must protect the interests that underlie utility regulation. That is, consistent with the purposes of regulation -- as enunciated by the Legislature -- 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.” *35-A MRSA §101*. Furthermore, when the Commission considers a reorganization involving telephone companies, the “consistent-with-the-interests” standard should be informed also by the policies underlying the telecommunications portions of Title 35-A. The “Telecommunications” chapters (Chapters 71-79) of Title 35-A identify ratepayers’ interests more particularly.

Section 7101 sets out the general legislative policy that telecommunications services – both voice and broadband -- should be available to all customers at affordable rates. Subsection 1 directs that “telephone service shall continue to be universally available, especially to the poor, at affordable rates.” *35-A MRSA § 7101(1)* (emphasis added). Subsection 2 continues the same theme with respect to broadband services, declaring, “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.” *35-A MRSA § 7101(2)* (emphasis added). Subsection 4 pushes that theme even further, stating, “computer-based information services and information networks are important economic and educational

Order at 1 (Oct. 1, 1996). See also: Northern Utilities, Request for Approval of Reorganization (Merger and Related Transactions), Docket No. 2000-322, Order at 5 (June 30, 2000).

resources that should be available to all Maine citizens at affordable rates. *35-A MRSA §7101(4)* (emphasis added).⁸

In summary then, as the Commission determines whether the proposed merger is “consistent with the interests” of telephone ratepayers, it should approve the transaction only if the Commission can be sure that the new FairPoint NNE entity will be able to provide adequate, reliable, and affordable telecommunications services – both voice and broadband –in all areas of the state. That is, if the effect of the transaction proposed by Verizon and FairPoint 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.”

III. DESCRIPTION OF THE TRANSACTION.

As joint applicants, FairPoint and Verizon are seeking approval for a transaction under which FairPoint will acquire Verizon’s “Northern New England” (NNE) telephone operations in Maine, New Hampshire and Vermont in a tax-free (Reverse Morris Trust) transaction. Under the proposal Verizon will first separate its NNE operations to a subsidiary specifically created for purposes of this transaction— “Spinco.” That “Spinco” will then be spun off and immediately merged into FairPoint producing the new company. FairPoint management expects a closing on the transaction by January 31, 2008. Thereafter, FairPoint and its new employees will start to operate the new NNE entity. That means that 2008 will be a transitional year during which

⁸ The language in Chapter 73 goes even further to identify the interests of ratepayers as ‘pocket-book’ interests -- i.e., interests in low and affordable rates. Overall, Section 7303 requires that the Commission take special steps to protect customers against unreasonable increases in the rates for local exchange service. Section 7303(2) declares that the Commission “shall establish rates for telephone companies which will preserve traditional flat rate local telephone service at as low a cost as possible, allowing for unlimited local exchange calling for a single monthly fee as the standard phone service in the State for both business and residential customers. “ *35-A MRSA Section 7303(2)* (emphasis added).

FairPoint will devote extensive resources to integrating and establishing operating control of the NNE properties.

FairPoint characterizes itself as an “acquisition company.” In the past it has focused on “small and mid-size, privately and publicly owned local exchange carriers, as well as properties sold by the regional Bell operating companies.”⁹ Since its start in 1991, FairPoint has acquired 35 small telephone companies, 31 of which it continues to operate. FairPoint currently operates in 18 states. As an “acquisition company”, FairPoint must continuously generate the cash flow necessary to fund both the operations of its companies, and the financial obligations stemming from its debt and equity.¹⁰

FairPoint’s acquisition of Verizon NNE is highly unusual among utility mergers in that a smaller company is acquiring a substantially larger entity. Depending on the measure of size used, Verizon’s NNE operations are about four to six times as large the present FairPoint operations.¹¹ For example, FairPoint’s access lines will increase from about 308,000 at present to 1.7 million post-merger. FairPoint’s annual revenues will increase from about \$263 million pre-merger to \$1.2 billion post-merger.¹² The significance difference in size means that FairPoint cannot operate the acquired properties with its existing internal “back office” management and operational support systems and personnel.¹³

⁹ Direct Testimony of David Brevitz, p. 14. (FairPoint Corporate Fact Sheet).

¹⁰ Brevitz Direct, p. 16.

¹¹ Brevitz Direct, pp. 12-13.

¹² FairPoint Communications Transaction Announcement, pp. 12-15, cited in *Brevitz Direct*, p.12.

¹³ For its previous acquisitions of rural local exchange carriers (LECs), FairPoint could integrate the new company into existing FairPoint operations and systems, or maintain stand-alone functions as desirable. For the acquisition proposed here, FairPoint cannot integrate Verizon’s three-state NNE operations into existing back-office operational and management systems. Instead, FairPoint must create new systems from the ground up. *Brevitz Direct*, pp. 18-19.

The acquisition by the relatively modest-sized FairPoint of the massively larger NNE operations will create a daunting integration challenge for FairPoint management. In particular, FairPoint must create the various systems to operate its NNE entity essentially from scratch, requiring an initial investment in new operating systems of approximately (and at least) \$200 million. However, the FairPoint's need to pay for the acquisition will create another significant burden. FairPoint will finance its acquisition of the NNE operations with a mix of debt and equity capital. With the Spinco merger, Verizon shareholders will receive 53.8 million FairPoint common equity shares, or about 60 percent of the post-merger shares.¹⁴ Because the price used in the transaction for valuation of the FairPoint shares was \$18.88 per share, the market value of the shares going to Verizon shareholders is an estimated \$1.015 billion. In addition, FairPoint will assume \$1.7 billion in new debt, including an eight-year term note. This brings the total transaction value to \$2.715 billion. As explained by Verizon witness Stephen Smith, it is expected that of the \$1.7 billion in debt, Verizon will receive \$900 million in cash as a special dividend and \$800 million in the form of debt that Verizon can "swap" to retire its existing debt.

As currently proposed, the transaction will increase the level of FairPoint's debt substantially. The \$2.715 billion total cost for the NNE operations compares to FairPoint's current market capitalization of about \$600 to \$700 million. FairPoint today also has about \$600 million in outstanding long-term debt. After the transaction closes, FairPoint's total debt will increase sharply to approximately \$ 2.5 billion, or a four-fold increase.¹⁵ However that \$2.5 million in FairPoint debt is not being incurred simply to fund the operating needs of FairPoint's new NNE entity. Instead, that debt is being incurred to refinance FairPoint's existing debt, and

¹⁴ Presently, FairPoint has 35.1 million shares outstanding, resulting in total post-merger shares of 88.9 million. *Kahal Direct*, p. 9, ll. 3-5.

¹⁵ FairPoint S-4A, page 78.

to provide \$1.7 billion for elimination of existing Verizon debt.¹⁶ In other words, much of the debt will be incurred in order to permit Verizon to de-leverage.¹⁷ That is a good bargain for Verizon’s shareholders, but it represents an additional burden that FairPoint must carry.

FairPoint’s debt currently is near the high end of companies viewed as comparable by the Joint Applicants, as measured by the debt/EBITDA ratio. This ratio for FairPoint post-transaction would remain at the top of the scale among companies deemed comparable by Joint Applicants.

Page C-1-13 of the July 2, 2007 Form S-4A shows the following “Comparable Company Analysis”, from the Lehman Brothers presentation materials:

	Current Dividend Yield	Dividen d Payout Ratio	Total Debt/LTM EBITDA
Alaska Communications	5.6%	75.0%	3.7x
Citizens Consolidated Communications	7.1%	65.0%	3.4x
Iowa Telecom	7.6%	70.0%	4.4x
Windstream	8.5%	78.0%	3.9x
Embarq	7.2%	81.0%	3.3x
FairPoint	3.8%	39.0%	2.4x
	8.4%	91.0%	4.9x ¹⁸

The Commission should not accept a proposed transaction which results in the public utility providing an essential and necessary service carrying among the highest debt/EBITDA ratios in the U.S.

¹⁶ Brevitz Direct, p. 24, ll. 5-11.

¹⁷ The amount of debt that would be borne by FairPoint was an important consideration for Verizon. Its original information letter, sent to sent to parties possibly interested in purchasing the NNE properties, asked for [BEGIN CONFIDENTIAL] [REDACTED] [END CONFIDENTIAL]

¹⁸ Brevitz Direct, page 34-35.

FairPoint already pays a significant amount of dividends each year. Since it became a publicly traded company in 2005, FairPoint has paid dividends at the rate of \$1.59 per share per year. That level of dividends equates to approximately 8% yield.¹⁹ Accordingly, FairPoint can be considered to be a “high debt/high dividend”²⁰ entity. Its overall risk profile is high.²¹ The interest payments associated with its debt, together with FairPoint’s dividend payments, represent a significant outflow of cash. In fact, the resulting large demand for cash to fund those fixed financial payment obligations (debt interest and principal, and dividends) have caused some stock analysts to forecast that FairPoint’s dividend level is not sustainable.

IV. FINANCIAL VIABILITY

A. As Proposed, the FairPoint NNE Entity Will Not Be Financially Sound.

Verizon and FairPoint are asking the Commission to approve a transaction in which responsibility for Maine telephone service would be shifted from financially-strong Verizon to a financially-weak FairPoint NNE entity. The risks associated with FairPoint’s highly-leveraged capital structure and its high-yield dividends are high,²² and therefore not consistent with the interests of Maine’s telephone customers. In addition, FairPoint is subject to a very large scale

¹⁹ Matt Kahal shows that in fact FairPoint’s dividend yield is above the average of “high dividend ILECs”, and in fact above the yield of any other “high dividend ILEC.” *Kahal Direct, Schedule MIK-3*.

²⁰ Since FairPoint became publicly traded, stock analysts have registered significant doubt as to whether FairPoint can maintain its stated dividend level, because, along with its high interest expenses, its dividend payout ratio is high, and is projected to go even higher, exceeding 100%. If those levels were to occur, the only way for FairPoint to pay its dividends would be to borrow money – a business practice that is not sustainable in the long term. *David Brevitz, Direct, p. 16, ll. 12-16*.

²¹ *David Brevitz Direct, p. 15, l. 24*.

²² A “high debt/high dividend” rural LEC is at the upper end of the risk spectrum for both equity and debt components of the capital structure. Higher debt leverage increases the risk that fixed payments of principal and interest cannot be paid, all other things equal. Higher dividend yield increases the risk that indicated dividend levels cannot be paid, all other things equal. *Brevitz Direct, p. 35, ll. 3-7*.

and crucial systems development and implementation. To the extent that its financial projections are not realized the FairPoint NNE entity will be in considerable financial distress. Accordingly, unless the transaction is restructured so that FairPoint's debt level is reduced by \$600 million, and unless FairPoint agrees to reduce the level of its dividend, the Public Advocate urges the Commission not to approve the "reorganization" that is being proposed by FairPoint and Verizon.

Under the transaction as proposed, FairPoint will start its new existence with an unadjusted net debt leverage of 5.7 times EBITDA in 2008, and 4.3 times or better in succeeding years. FairPoint's current (2006) debt leverage is 4.5 times EBITDA. FairPoint's S-4A filing shows that the new company is projected to have \$2.516 billion in debt on its balance sheet at the end of 2008.²³ That debt is not incurred by FairPoint pursuant to any particular plan or proposal for its capital structure. Indeed, FairPoint has no such plan. Instead, the debt is being assumed solely as a result of the proposed transaction, and the amount of that debt is driven by Verizon's desire to structure the transaction so that it can reduce the amount of its own debt.

The proposed debt consists of two components: proceeds from a bank loan agreement and a bond debt issuance. The bank loan is to be provided pursuant to a commitment agreement struck one year in advance of the projected closing of the transaction. But final loan documents have not been negotiated between FairPoint and its banks. Furthermore, there is no certainty as to what interest rate FairPoint will have to pay on that debt. While the agreement does address the question of interest rates, there have recently been substantial changes in the credit markets that raise the question as to whether – when FairPoint attempts to make a final negotiation on the

²³ Brevitz Direct, p 41, ll. 1-2.

loan documents -- FairPoint will be permitted to pay interest on the same specific terms mentioned in the commitment letter.

Furthermore, the size of the projected bond issuance is substantial (\$793 million), and is not subject to any agreement whatsoever until the issuance is negotiated immediately prior to closing. The cost of those bonds will depend on conditions in the credit market at the time of issuance, which is likely to be impacted negatively by recent events. Current market conditions show that the cost of “junk bonds” is substantially higher than the interest rate projected in FairPoint’s financial model.²⁴ Current yield on “High Yield Constrained” bonds (Merrill Lynch) stood at 8.579% on Tuesday October 30th.²⁵ That interest rate is a full point higher than the assumed 7.5% rate that appears in FairPoint’s S-4A, at page 211. In short, the transaction, as proposed, subjects FairPoint to considerable “interest-rate” risk. Furthermore, because FairPoint’s financial projections depend so heavily on assumptions regarding the amount and cost of its debt, there is no certainty that FairPoint can maintain its financial viability.

The level of debt proposed in this transaction will obligate FairPoint to substantial fixed payments of principal and interest. In combination with FairPoint’s heavy dividend requirement, and required payment of taxes, operating expenses and capital expenditures, too many demands are placed on the projected cash flows to be suitable for a public utility providing essential services.

²⁴ Remember that because they have a below-investment-grade rating, FairPoint’s bonds are considered “junk bonds.”

²⁵ The Wall Street Journal, October 30, 2007, page C6. “Constrained” means that the index limits individual issuer concentrations to 2%, thereby providing for inclusion of a broader array of junk bonds.

The Commission should note that FairPoint's proposed debt load is significantly heavier than the debt load proposed in recent transactions, including the Sprint/Nextel and Alltel spin-offs. Neither Embarq nor Windstream was spun off with leverage as high as the 4.3x unadjusted leverage proposed for FairPoint. While the debt assumed by Embarq and Windstream was substantial, in relative terms those debt levels were substantially lower than proposed here. An objective of the Embarq spin-off was to enable investment-grade bond ratings. Embarq's net debt to EBITDA ratio was 2.5x at end of year 2006, and then dropped to 2.3x at the end of first quarter 2007, due to a long-term debt repayment of \$363m. That was a material debt repayment that occurred in Embarq's first year of existence, and was made possible by Embarq's significantly lower debt level. That is, Embarq was not required to service debt at over 4 times EBITDA, or pay a high-yield dividend. Windstream also has substantially lower debt leverage: it calculates a net debt to "OIBDA" at 3.1x.²⁶ In order for FairPoint to approach the same level of debt leverage, there must be a substantial reduction of its debt. In fact, even the \$600M bond debt reduction -- which we recommend as one of the conditions that the Commission should impose if it approves this transaction -- is not sufficient to bring the debt leverage ratio to the current Windstream ratio until approximately 2013, and that projection assumes that FairPoint applies its free cash flow to debt repayment in the intervening years -- which FairPoint has no stated intention of doing.

Because FairPoint has the public-utility obligation of providing an essential service, and, at the same time, faces the uncertain outlook of the wireline industry, it is essential that FairPoint not be over-leveraged. That is, FairPoint should not have more fixed obligations than cash to pay those obligations. Under the proposed transaction the bond debt that FairPoint will assume

²⁶ Brevitz Direct at page 32.

is more expensive than the bank loan that it takes on. Hence, that bond debt is the obvious place to reduce debt and the associated fixed interest and principal repayment obligations. As recently noted in Business Week:

For most pure wireline players,... [e.g., FairPoint], ... the prospect of flat or declining revenues is not just a future possibility but a current reality. Given continuing wireless substitution and cable's inroads into the residential telephone business, growth prospects for their core businesses are minimal at best, as reflected in our mostly negative outlooks for the pure wireline companies. The pressure to satisfy equity investors lessens their ability to reduce debt to offset challenging business prospects.”²⁷

Here, because FairPoint has shown that it is unable to do so itself, the Maine Commission must take steps to ensure that FairPoint is not so overly leveraged that it is unable to meet “challenging business prospects.” Therefore, we urge the Commission to approve the proposed transaction only if the Commission imposes a condition that the transaction be restructured by Verizon and FairPoint so that the amount of debt that FairPoint would owe to Verizon is reduced by \$600 million.

B. FairPoint Has An Aggressive Policy of Paying High Dividends.

FairPoint has a very aggressive dividend payout policy. FairPoint pays out dividends in amounts that are more than twice as large as its earnings.²⁸ The amount of those dividend payments approaches 80 or 90 percent of FairPoint’s free cash flow.²⁹ Its dividend payout ratio is one of the highest in the telephone industry (including the portion of the telephone industry

²⁷ Richard Siderman, “Cable vs. Telco: The Battle Heats Up,” *Business Week*, p. 4, (October 10, 2007) http://www.businessweek.com/investor/content/oct2007/pi20071010_242433.htm?chan=search

²⁸ Kahal Direct, p. 19, ll. 19-20. FairPoint is able to pay out a high level of dividends because not only does it pay out as dividends all of its earnings, but it also pays out a portion of its depreciation as well, thereby “shrinking” the company. *Id.*, ll. 20-23.; *see also: Brevitz direct, p.23, ll. 5-8; and R. Barber (Public) Direct, p.19, ll. 15-16.* Randy Barber notes that in 2006, FairPoint’s dividends were 77% greater than its net income. *Id.*

²⁹ *Id.*

that has adopted a high dividend/high leverage strategy.)³⁰ Such a high dividend yield increases the risk that dividend levels cannot be paid, and creates a situation where the utility that would deliver telephone service to 87% of Maine customers might be a company that will go into financial distress.

An additional component of FairPoint's top heavy financial structure is its use of a "high yield" dividend.³¹ That high yield dividend consumes a large portion of FairPoint's cash flow, and represents a "committed" use of funds.³² All other things being equal, FairPoint's required payments of \$142 million in dividends eliminate cash that is needed to enable FairPoint to satisfy its utility service obligations. That is, FairPoint must have that cash available for items such as the capital expenditures and operating expenses necessary to reach adequate service quality levels. FairPoint has stated a number of times that the dividend payment constitutes a "cushion," that its shareholders must bear the risks associated with the transaction and financial projections, and that if necessary, dividend payout will be reduced to accommodate service needs. However, "the devil is in the details," and FairPoint has proffered no "bright lines" that define when the dividend should be reduced. Furthermore, as FairPoint manages the company and its operations – if FairPoint were to be short of cash -- the Commission would only be able to determine later, and with difficulty, whether FairPoint chose, for example, to skimp on operating expenses, or capital expenditures, in order to preserve the level of its dividend. In short, in order to ensure that the new FairPoint NNE entity will be able observe its obligation as a public utility, the Commission should impose a condition that requires that FairPoint in fact to reduce its dividend as necessary to provide adequate and efficient service to its utility customers. Absent any other

³⁰ Kahal Direct, p. 11, ll.11-15.

³¹ Brevitz Direct beginning at page 34; Kahal Direct at xxx.

³² Brevitz Direct, page 39.

dividend reductions required by the Commission on order to gain approval of the proposed transaction, the Commission should require that this “cushion” be utilized if any of the following events occurs:

- FairPoint NNE operating expense projections for any given year are exceeded by more than 5% (in absolute dollars): greater of 25% reduction or the amount of operating expense increase over the projections, net of tax impact;
- FairPoint’s NNE capital expenditure projections for any given year exceed actual capital expenditures by more than 2% (in absolute dollars): greater of 25% reduction or the amount of capital expenditure increment under the projections;
- If the Commission does not require FairPoint to limit its proposed debt leverage at inception: 50% dividend reduction is required in any year in which unadjusted net Debt/EBITDA is greater than 4.5x, with the proceeds deployed to pay down debt; and,
- If the Commission does require FairPoint to limit its proposed debt leverage at inception as recommended by OPA: 25% dividend reduction is required in any year in which unadjusted net Debt/EBITDA is greater than 4.0x, with the proceeds deployed to pay down debt.

C. FairPoint Is Significantly Exposed To Interest Rate Risk.

However, it would not only be the high percentage of debt that creates risk for FairPoint. The nature of the debt that FairPoint NNE would hold will mean that the new entity would be significantly exposed to interest-rate risk. FairPoint has secured bank commitments for \$2.08 billion in long-term debt – debt that is to be carried at a variable interest rate.³³ The risk, of course, is that interest rates will continue to rise, forcing FairPoint NNE to pay the increased

³³ Brevitz Direct, p. 40-41. The bank debt bears interest at a variable rate based on a chosen short-term interest period (1, 2, 3, or 6 months as selected by the borrower, or 9 or 12 months if agreed to by the lender) based on Adjusted LIBOR (London Interbank Rate) plus an additive margin, or an interest rate that appears to be fixed based on a “prime rate” plus an additive margin. *Brevitz Direct*, p. 41, ll. 10-14, citing FairPoint’s Form S-4A, filed July 2, 2007, p. 135.

fixed charges associated with its substantial amounts of variable-rate debt.³⁴ Those higher interest expenses would have to be paid, and would pre-empt FairPoint from using cash that had been planned (or is necessary) for other purposes -- e.g., dividends, or capital investment, or operating expenses. In short, FairPoint's high leverage makes the new entity significantly dependent on conditions today's debt market.

Furthermore, FairPoint has failed to take steps that are sufficient to "hedge" against the interest-rate risk that it would face going forward. As a result, the interest rate risk for FairPoint NNE could not be eliminated. It can only be transferred or mitigated at some cost. *Brevitz Direct*, pp. 42-43.

In order to "hedge" against its existing debt, FairPoint has used interest-rate swap agreements. However, those agreements apply only to FairPoint's existing debt – debt to be repaid with proceeds from the new credit agreement that would go into effect with the proposed transaction.³⁵ FairPoint notes that it is possible to fix the interest rate of its new debt, but that "hedging" would come at some cost: FairPoint NNE would be required to a blended interest rate of 6.3% on \$550 million.³⁶ But FairPoint also noted that it might not be able to hedge on its new debt: "to the extent interest rates increase in the future, we may not be able to enter into a new interest rate swap, or purchase an interest rate cap or other interest rate hedge on acceptable terms."³⁷ In summary, FairPoint can seek to use interest rate hedges, but those hedge

³⁴ There is no doubt about the risk that interest rates will rise, and FairPoint recognizes that risk. The federal funds rate that is contained in [BEGIN CONFIDENTIAL] [REDACTED] [END CONFIDENTIAL] However, the federal funds rate, as of July 12, 2007, was already higher -- at 5.25%. *Brevitz Direct*, p. 41, ll. 20-24.

³⁵ *Brevitz Direct*, p. 42, ll.5-7.

³⁶ *Id.*, ll. 7-10.

³⁷ *Id.*, ll. 13-15, quoting FairPoint Form 10-K, filed March 14, 2006, at page 18.

mechanisms cannot eliminate the interest rate risk that would exist for FairPoint -- given its heavy debt leverage, and its use of variable interest rates for large portions of that debt.³⁸

Furthermore, FairPoint is not committing to reduce the risk that is caused by its highly leveraged capital structure. FairPoint is not [BEGIN CONFIDENTIAL] [REDACTED]

[REDACTED] [END CONFIDENTIAL] its debt.³⁹ FairPoint's financial model suggests that by the year [BEGIN CONFIDENTIAL] [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] [END CONFIDENTIAL]⁴⁰ *Id*

D. Even FairPoint's Margin Over "LIBOR" Is Not Fixed.

The bank debt that the FairPoint NNE entity would hold under the proposed transaction requires that FairPoint pay either (1) interest at a variable rate based on a chosen short term-interest period based on Adjusted LIBOR (London Interbank Rate) plus an additive margin, or (2) interest at a rate that appears to be fixed based on a "prime rate" plus an additive margin.⁴¹

In either case, the "additive" margin over LIBOR is not yet fixed.⁴² In other words, under either

³⁸ *Id.*, p. 43, ll. 1-3. Even with its limited ability to hedge interest rates, FairPoint remains exposed to trends of increasing interest rates, particularly since [BEGIN CONFIDENTIAL] [REDACTED]

[REDACTED] [END CONFIDENTIAL] *Brevitz Direct*, p. 43, ll. 3-8.

³⁹ 10/3/07 TR, p. 3, ll. 15-22.

⁴⁰ In its response to OPA-I-30-6, FairPoint states [BEGIN CONFIDENTIAL] [REDACTED] [END CONFIDENTIAL] *OPA Exhibit# 25*.

⁴¹ *Brevitz Direct*, p. 41, ll. 10-14.

⁴² *Brevitz Direct*, p. 43, ll. 14-22. FairPoint's S-4A states "Under the new credit facility, FairPoint and Spinco expect to make borrowings at Adjusted LIBOR Plus a margin which in the case of the revolving credit facility will be subject to a leverage-based pricing grid to be agreed by the parties. ... The applicable margins under the new credit

option FairPoint NNE would face further significant interest rate exposure if changing market conditions require higher margins – particularly if those margins are higher than currently used in FairPoint’s financial model.

E. Under the Transaction Proposed, FairPoint NNE’s Capital Structure Would Result In Higher Telephone Rates For Maine Customers.

For Maine’s telephone customers, the capital structure of the proposed FairPoint NNE entity is bad news. So long as FairPoint is subject to rate-of-return regulation, FairPoint’s weak financial condition will give the Company an incentive to seek higher rates of returns through rate filings.⁴³ Currently, FairPoint’s high debt leverage causes it to have “junk bond” credit ratings, for which investors demand a higher return, as compared to the “investment grade” credit ratings that are given to the debt of Verizon. If the Commission were to approve the transaction as proposed, FairPoint NNE would seek a higher cost of debt than Verizon currently receives. Because of its aggressive dividend policy, FairPoint would also seek the same or a higher cost of equity than sought by Verizon.⁴⁴ All other things equal, the result would be higher telephone rates for Maine telephone customers – a result that is not “consistent with the interests of utility ratepayers.”

F. Key Terms of the Proposed Transaction Favor Verizon As It Exits Maine, Rather Than Providing Benefits To FairPoint’s Customers, or Investors.

It appears that a principal reason that FairPoint is to assume so much debt in this transaction is that the debt financing provides considerable benefit to Verizon. *See: Brevitz*

facility have not yet been negotiated.” *Brevitz Direct*, p. 43, citing FairPoint Form S-4A, filed July 10, 2007, at page 135, (emphasis added).

⁴³ *Brevitz Direct*, p. 38, ll. 7-9.

⁴⁴ *Brevitz Direct*, p. 38, ll.2-3.

The Joint Applicants seek to make much of the fact that the per-line transaction price for the NNE territories is much less than the per-line price for Verizon’s most recent prior sale—that of Hawaiian Telecom to The Carlyle Group. However, that is a comparison of a non-taxable (RMT) transaction to a taxable transaction. The difference in pricing (\$1800 per line vs. \$2340 per line) can be explained by compensating for taxation. After taxes, the pricing of the transactions is comparable, and in both cases the transactions constituted sales of “the car without the engine.”

G. The Proposed Transaction Also Will Not Be Consistent With the Interests of Verizon’s Investors.

Under the terms of the proposed transaction, Verizon stockholders will hold approximately 60% of FairPoint’s common stock, but only at the moment in time that the transaction is closed. The composition of FairPoint shareholders will immediately and substantially change after that point. If institutional requirements force those Verizon stockholders to sell their FairPoint shares after completion of the merger, more than likely the market price of FairPoint’s stock will decline.

Verizon’s common stock is included in index funds and exchange-traded funds that are tied to the Dow Jones Industrial Average and to the Standard & Poor’s 500 Index.⁴⁸ FairPoint’s common stock is not expected to be included in those indices at the time of the merger. Furthermore, one of the “investing guidelines” that is known to affect portfolios of institutional investors is a company’s bond credit ratings. It is likely that, at the time of closing, FairPoint’s debt will continue to be rated as “below investment grade.” Therefore, FairPoint’s common stock will not meet the investing guidelines of the various institutional investors that are required

⁴⁸ Brevitz Direct, p. 58, ll. 28-30, quoting FairPoint’s Form S-4A.

to maintain portfolios that reflect the index funds mentioned above. As a result, those index funds (such as the Standard & Poor's 500 Index), exchange-traded funds, and institutional investors may be required to sell the FairPoint common stock that they receive at the time the merger would close. Those sales would have an immediate negative effect on the price of FairPoint's common stock. Furthermore, those sales may also make it more difficult for FairPoint to raise additional capital by selling equity securities at the time and price that it desires.

In short, because FairPoint's debt has a below-investment-grade rating, Verizon stockholders will be exposed to immediate declines in the market value of their investments directly after the closing.⁴⁹ For, that reason, the proposed transaction is not consistent with the interests of Verizon investors.

H. The Results of FairPoint's Financial Model Are Not "Saved" by Comparisons to Other Companies.

In an attempt to show that the projections from FairPoint's model are "conservative," Mr. King's rebuttal testimony compares data from public sources to the FairPoint NNE confidential data. Mr. King's analysis is overly broadbrush, and ignores more granular data that is available from the same sources. When the more granular data is considered and analyzed, Mr. King's broad conclusion -- that "FairPoint could reasonably be expected to out perform assumptions implicit in the NNE projections"⁵⁰ due to substantial revenue and margin opportunity as compared to "guideline companies" -- is demonstrably wrong. In his Table 3.2,

⁴⁹ See: Brevitz Direct, pp. 58-59

⁵⁰ King Rebuttal, page 14, lines 17-20.

Mr. King presents disaggregated revenue data for NNE at, but he presents only aggregated total revenues for guideline companies in his Part 4 tables.⁵¹

This is a crucial issue since FAIRPOINT uses this analysis to “validate” the projections from the financial model. Upon closer examination, Mr. King’s analysis provides no such validation to the projections, and in fact shows that there is little if any “low hanging fruit” to be achieved by FairPoint outside the projections.

One implication of Mr. King’s analysis is that over the years Verizon has left substantial revenues “on the table” in operating the three NNE states. However, it is extremely unlikely that Verizon would leave any significant revenue opportunities untaken. While there may be some revenue opportunities available, Verizon has no doubt sought to take advantage of all available significant revenue streams, and this would be represented in the baseline Verizon financial data from which FairPoint projects.

This analysis focuses on Mr. King’s conclusions regarding revenues, since he “believe[s] the ‘low hanging fruit’ available to FairPoint comes more in the form of increased revenue per line than further reductions of costs per line.”⁵² The review covers essentially the same materials as Mr. King (SEC Form 10-K reports, and company financial reporting) for 2006 to present a more granular analysis of the purported revenue opportunity for FairPoint to outperform its financial projections. The total revenues for the guideline companies were broken down to include the categories of local & long distance services, access services & universal service fund receipts, and data & internet services. These categories of revenues can then be compared to the

⁵¹ The “comparable companies” have a significant element of non-comparability since Windstream data is used for 2006 calculations, while Valor data is used for “the same” company for 2004 and 2005 calculations. The rationale must be that Valor merged into and with Alltel in 2006 to create Windstream, thus technically they are the “same company”. However, Valor and Alltel are two very different companies. Thus the obvious and substantial differences between Valor for 2004 and 2005, and Windstream for 2006: comparing for example the far right column of King Tables 4.1, 4.2, and 4.3.

⁵² King Rebuttal, page 18, lines 2-4.

same categories for NNE to assess the validity of future “low hanging fruit” or new revenues to outperform the FairPoint projections. The same divisor is used as Mr. King—average access lines. The results are presented in Tables 1-4 to the Brevitz Surrebuttal.

Anomalous results are created by Mr. King’s use of total company revenues, rather than disaggregated revenues. The use of total company revenues for “guideline” comparison purposes implicitly includes items that the Commission should not consider to be services offered by the FairPoint NNE. Indeed, by using total company revenues, Mr King has included the revenues for services not offered by FairPoint NNE, which will therefore give those guideline companies the opportunity to outperform the FairPoint financial projections, as follows:

1. CLEC/Fiber Transport businesses are included: Citizens’ revenues include those from ELI, a CLEC which it sold in 2006; Consolidated “Other Operations” revenues include the revenues of a transport business in Texas that it acquired from TXU; and CenturyTel’s revenues include those from its fiber transport/CLEC business including KMC. Each of those revenues are not included in the analysis since the Commission should not assume that the NNE financial projections will be substantively and positively augmented by a future (speculative) acquisition of a fiber transport/CLEC entity.
2. Directory Revenues are included: Citizens’ has substantial directory revenues, and Windstream had a directory business which it sold in late 2006. These revenues are not included in the analysis since the Commission should not assume that the NNE financial projections will be substantively and positively augmented by a future (speculative) acquisition of a directory operation, particularly given the existence of the non-compete agreement barring FairPoint from certain directory services.
3. Product/Equipment sales revenues are included: Windstream has a Product Sales business segment that was responsible for over 10% of Windstream’s 2006 revenues. These revenues are not included in the analysis since the Commission should not assume that the NNE financial projections will be substantively and positively augmented by a future (speculative) acquisition of an equipment manufacturing business.

The results of the disaggregated analysis of the local and long distance services category are shown in Table IV of the Brevitz Surrebuttal, and repeated below. That table shows that revenues per line for NNE are very near the top end of the range. This suggests that, at best, only minimally increased revenues would be available to FairPoint, outside of a local rate increase through a rate case, which OPA does not favor. Substantial additional revenue opportunities from increasing vertical services sales do not exist since Verizon has already plumbed the depths of this area through its package bundles, and bundles of vertical services. There is no “low hanging fruit” here.

[BEGIN CONFIDENTIAL]

[REDACTED]

[END CONFIDENTIAL]

The results of the disaggregated analysis of the access services and USF category are also shown in Table IV. It shows that NNE’s revenues per access line from this category are very near the bottom of a very wide range. In fact, NNE is multiples below the high end of the range. There is no opportunity here for substantial revenue increases due to the fact that interstate access charges are price capped, intrastate access charges are driven by “parity” rates, access

rates are declining, and there are pressures to reduce universal service funds along with limits on who can receive universal service funds. There is no “low hanging fruit” here.

[BEGIN CONFIDENTIAL]

[REDACTED]

[REDACTED]

[END CONFIDENTIAL]

The results of the disaggregated analysis of the data & internet category are also shown in Table IV. It shows that NNE’s revenues per access line from this category are at the bottom of a wide range. There is revenue opportunity here, but it is not “low hanging fruit” due to the fact that DSL service revenues **[BEGIN CONFIDENTIAL]** [REDACTED]

[REDACTED]

[REDACTED] **[END CONFIDENTIAL]**

Furthermore, the DSL model results show the importance of assumptions regarding charges between affiliates, in particular the DSL line sharing charge assumed in the model.

[BEGIN CONFIDENTIAL]

[REDACTED]

[REDACTED]

[END CONFIDENTIAL]

While only 2006 revenues are analyzed here, similar results would obtain for a similar analysis of 2004 and 2005 revenues, in terms of revenues/business from the same exchanges. The results would be relatively the same given consistent accounting treatments between periods, which can be expected.

Mr. King's assertion that "FairPoint could increase annual revenues by between 10 and 25 percent"⁵³ is not borne out by analysis of data at a more granular level. The FairPoint financial projections are not "conservative" in that there is substantial revenue and margin opportunity not included in the projections, as alleged by FairPoint. The most significant revenue opportunity is matched by equally significant costs.

I. FairPoint's Financial Model Fails To Show That FairPoint and Its Spinco Subsidiary Will be Financially Viable.

In 2006 FairPoint's management created a financial model that was the basis for its decision to enter into the proposed transaction.⁵⁴ The model was developed as a tool to assemble

⁵³ King Rebuttal, page 16, lines 1-2.

⁵⁴ Direct Testimony of Michael Balhoff, p. 15, ll. 22-23. The model was presented to Fair Point's Board of Directors over the last half of 2006, and was continually updated as FairPoint completed additional due-diligence activity.

and present the financial data for the operation of the Spinco's properties.⁵⁵ However, there are points at which the model appears to be management's effort to "sell" the proposed transaction, rather than to determine objectively whether the proposed FairPoint NNE entity would be financially viable. The model projects FairPoint's expectations of FairPoint's management for the operating and financial performance of the combined FairPoint company based on the assumptions that FairPoint claims are most appropriate.⁵⁶

In short, FairPoint's financial model and its projected results are not sufficiently reliable for the Commission to use as a basis for determining whether the proposed transaction would result in a financially viable public utility.⁵⁷ The chief reason why the Commission should not accept FairPoint's financial model (and its results) is that the inputs to the model are not reasonable.⁵⁸ In many cases it is impossible to trace and verify the sources for the model's data and assumptions.⁵⁹ Also, in some cases, input data cannot easily be modified. That means that the model does not permit the user to test the changes that would result from different assumptions. In short, the fact that some inputs are "hard-wired" prevents the Commission from

⁵⁵ The model forecasts FairPoint's revenues and expenses over the period from 2007 through 2015, with special emphasis on the results for the period between 2008 and 2012. Results are provided on a total FairPoint basis and on a Verizon Northeast (NNE) carrier basis. No information or forecasts are provided on a stand-alone basis for the Verizon-Maine portion of the NNE properties. *Loube Direct*, p.24, ll.15-21.

The fact that the model does not provide Maine-specific results is consistent with the understanding that the model was developed by FairPoint management in order to persuade FairPoint's directors to approve the proposed transaction. At the same time, the fact that the model does not provide Maine-specific results makes it more difficult for the Maine Commission to answer the question of whether the proposed transaction is consistent with the interests of Maine's telephone ratepayers. *35-A MRSA §708(2) (A)*. FairPoint has the burden of making that showing. Without state-specific information, it is difficult for FairPoint to satisfy that burden.

⁵⁶ Walter Leach Rebuttal, p. 7, ll.6-9.

⁵⁷ Brevitz Direct, p. 95, ll. 21-23.

⁵⁸ Tests for input reasonableness include comparing the inputs to other data sources, reviewing the internal consistency of input assumptions, and ensuring that the predicted inputs conform to a realistic picture of future events. *Loube Direct*, p.28, ll. 8-10.

⁵⁹ See: Brevitz Direct, pp. 78-81, generally.

modifying the model's data and assumptions -- so as to "clean up" the model for the Commission's own use. The use of those hard-wired inputs only underscores the impression that the point of the financial model is to "sell" the transaction. Numerous inputs to the model are apparently derived from external programs or spreadsheets that have not been included with the provision of the model, or are the result of formulas which have been eliminated in favor of simply showing values—which by themselves are untraceable as to source, assumptions or logic.⁶⁰

Furthermore, upon careful examination, the Commission will find that FairPoint's financial model fails to show that FairPoint and its Spincor subsidiary would be financially viable through the year 2012. Also, the model does not confirm that FairPoint would have the financial resources to finance its DSL build-out plan.

Specifically, the financial model is flawed because its inputs are based on a series of unreasonable and unrealistic estimates of the FairPoint NNE's costs and revenues. Some of its assumptions are overly optimistic; some are inherently inconsistent. Other assumptions fail to consider the impact of competition from the cable companies. In short, because the FairPoint model has a good number of faulty assumptions, the Commission should not rely on its results as a demonstration of the financial viability of the proposed combined company. In particular, the Commission should take a careful look at the assumptions made in the model as to the growth or decline in subscriber volumes and revenues. For instance, consider the amounts of "Other ISP" revenue that the financial model assumes that FairPoint would be able to generate after the closing.

⁶⁰ Brevitz Direct, page 79, lines 10-13.

1. “Other ISP” Revenues Are Overstated.

According to FairPoint’s financial model, “Other ISP” revenues would increase substantially over the 2008-2015 period of the model.⁶¹ However, FairPoint’s assumption that it can increase “Other ISP” revenues is misplaced. It is unlikely that the new entity’s “Other ISP” revenue will increase because its chief competitors – the cable companies -- do not charge for those “Other-ISP” services. Time Warner Cable – the major competitor in Maine for high-speed internet services -- already includes most of the “Other ISP” services in its high-speed offering at no extra charge.⁶² Hence, the market will not allow FairPoint to charge for those services.

Overall, the financial model fails to account for the effect of increased competition from Time Warner Cable (TWC). In the model, the data used for Verizon revenues is data derived from the years prior to 2007. During that pre-2007 period, Time Warner had not yet taken charge of the large areas in northern New England -- i.e., large areas of Verizon NNE territory -- where TWC’s predecessor, Adelphia Cable, was providing service. By contrast, starting in 2007, Time Warner has rolled-out its cable-telephone services in Verizon territory, and going forward, is marketing those services aggressively. The efforts of Time Warner (and of other cable competitors) will have significant impacts both on the “Other ISP” revenues of FairPoint NNE, and on its local revenues.⁶³ By relying solely on pre-2006 data, and by failing to adjust for the

⁶¹ Loube Direct, p. 28, ll.14-16. According to FairPoint’s financial model, “Other ISP” revenue increases from [BEGIN CONFIDENTIAL] [REDACTED] [END CONFIDENTIAL] Loube Direct, p. 28, ll. 14-19.

⁶² Loube Direct, p. 29, ll. 1-7. For instance, presently Time Warner advertises that its Road Runner service includes, at no charge, “Free Anti-Spyware, Anti-Virus, Firewall protection, Anti-Spam, Pop-up Blockers, product upgrades and updates, and web support.” *Id.*

⁶³ The Commission should also question the reasonableness of the assumptions made in FairPoint’s model regarding revenues from local service. However, it is difficult to identify those assumptions. [BEGIN CONFIDENTIAL] [REDACTED]

impact of increased competition from Time-Warner, FairPoint's model is presents a financial picture that is -- quite simply -- too optimistic. That is, the model overstates the amount of "Other ISP" revenue that the new FairPoint NNE can expect to receive over the next four years.

2. Other Flaws in the Financial Model.

FairPoint's financial model relies materially on a series of other flawed assumptions regarding FairPoint's revenues and costs. Because those assumptions are not valid, the financial projections produced by FairPoint's model are not reliable. We list the most significant of those flaws here.

**** Unrealistic Assumptions As to Annual Operating Expenses.**

With respect to operating expenses, the assumption in the financial model is that for the 2008-2015 period FairPoint is expecting those expenses [BEGIN CONFIDENTIAL] [REDACTED] [END CONFIDENTIAL]⁶⁴ However, that assumption is completely unrealistic. For, example, it is not reasonable to assume, as the model does, that FairPoint NNE will have [BEGIN CONFIDENTIAL] [REDACTED] [END CONFIDENTIAL] wage increases for seven years. There is no reason to believe that, over the next seven years FairPoint's operating expenses will not be affected by cost increases from suppliers, increases in the cost of gasoline and electricity, wage increases, and other inflationary increases. Over the last five years, Verizon's NNE properties have had a unit operating-expense growth rate of about 6% to 7%.⁶⁵ In the twelve months ending March 31, 2007, FairPoint's per-unit operating expense increased by 8.1%.⁶⁶ It is unreasonable to expect that FairPoint can reduce that growth rate to the rate of growth assumed in its financial model.

FairPoint is projecting that as part of the transaction it can achieve \$60 to \$75 million in cost savings by replacing the support systems and network services formerly provided by Verizon with FairPoint's newly created systems and support. However, if FairPoint's operating expenses are greater than assumed in its financial model, the amount of those savings will be significantly reduced. The effect will be to reduce FairPoint's free cash flow.

[REDACTED] [END CONFIDENTIAL] *Brevitz Direct*, pp. 76-77.

⁶⁴ Direct Testimony of Michael Balhoff (Group I), p. 20, ll. 13-15 (Confidential)

⁶⁵ R. Barber Public Direct, p. 23, ll.3-4.

⁶⁶ *Id.*, p. 23, ll. 9-17.

**** No Basis for Estimate of Cash Expenses.** The estimate of cash expenses in the model does not have a verifiable source. Except for the costs that are contractual (i.e.,TSA and Capgemini costs), cash expenses cannot be traced to actual data -- such as trial balance data, FCC ARMIS data, or other financial data. That means that for the critical years 2005-2008, significant⁶⁷ percentages of the operating expenses that FairPoint projects cannot be tied to a verifiable source. *Brevitz Direct, p. 81, ll. 17-22.*

**** DSL Revenues Are Over-estimated.** FairPoint's projections of increases in numbers of DSL customers for the NNE entity are too optimistic. FairPoint's financial model relies materially on a rapid availability and up-take of DSL service. Yet those projections fail to take into account the fact that in FairPoint's new NNE territories, DSL up-take will not necessarily occur promptly, or on a broad scale. Over the past few years there have been significant problems in the three states in delivering DSL to rural areas. In short, FairPoint does not know the extent to which the existing network will support rapid DSL expansion and up-take by consumers.⁶⁸ *See: Brevitz Direct, pp. 83-85.*

Without a detailed implementation plan, FairPoint cannot be certain as to either the costs to deploy DSL, or the pace at which DSL up-take can reasonably take place. DSL revenues will be less than projected because FairPoint is more likely to lose a good number of customers to the competition offered by a Time-Warner's cable-telephony-bundle that includes high-speed internet access. *Brevitz Direct, p. 85, ll. 18-25.*

Also, FairPoint's model makes an unreasonably high projection of the size of the increases in Business DSL sales that would occur in the 2008-to-2012 period.⁶⁹ As a result, the model overstates the amounts of DSL revenue that the FairPoint would receive during those years.

⁶⁷ For the key years of 2005, 2006, 2007, and 2008, [BEGIN CONFIDENTIAL] [REDACTED] [END CONFIDENTIAL]
Brevitz Direct, p. 81, ll.17-22.

⁶⁸ FairPoint's projections of the up-take for DSL over the next four years cannot be accurate because it has not been able to develop the specifics of its broadband deployment plans: [BEGIN CONFIDENTIAL] [REDACTED] [END CONFIDENTIAL] *Brevtz Direct, p. 85, ll. 3-8, citing FairPoint's response to OPA II-10-1.*

⁶⁹ Loube Direct, p. 32-33. The explanation as to why the FairPoint model has overstated its estimate of the increases in Business DSL sales is an explanation that involves a good deal of confidential information. We will not repeat that explanation here. Instead, it can be found at pages 32-33 of Dr. Loube's Direct Testimony.

**** Unrealistic Volumes for UNE-P's and UNE-L's.** The model's projections of the revenues that FairPoint NNE would receive from business UNE-P and UNE-Loops are unrealistically high -- both because UNE-P is no longer required to be offered, and because growth rates for UNE-L's nationwide have not been so high as expected -- i.e., less than 3% annually.⁷⁰

**** Different Balances for Shareholders Equity.** The inputs to FairPoint's financial model with respect to the balances of shareholders equity are not reasonable. The model projects negative balances for shareholders equity that are significantly different than the balances that FairPoint has projected in its Form S-4A report to the Securities Exchange Commission (SEC). Negative equity is an indication of the financial weakness of FairPoint. In its SEC report, FairPoint projects that starting in 2007 shareholders equity will decline almost \$900 million dollars, to a negative \$218 million in 2015.⁷¹ However, FairPoint's financial model projects different balances for shareholders equity -- balances that are significantly [BEGIN CONFIDENTIAL] [REDACTED] [END CONFIDENTIAL]⁷² In short, the inputs used in the model—which do not reflect reality -- appear to be part of an effort to “sell” the proposed transaction.

**** Inadequate Detail on Capital Expenditures.** The model does not contain sufficient detail to analyze FairPoint's projected capital expenditures. FairPoint appears to have made the simple assumption that it would continue to make capital expenditures at the same rate as Verizon has in past years.⁷³ However, beyond that, no basis for the model's per-line calculations is shown.⁷⁴ All source data is hard-coded, with formulas or data source broken.

This lack of detail indicates that FairPoint's financial model is not based on any “ground-up” calculation of the capital expenditures that would be necessary in the next four years. That is because FairPoint did not have access either to detailed capital budget information or to the detailed plant records

⁷⁰ For UNE-L's, for the years 2008 through 2012, FairPoint's model projects [BEGIN CONFIDENTIAL] [REDACTED] [END CONFIDENTIAL] than the annual growth rates experienced for UNE-L's nationwide. *Brevitz Direct*, p. 86, ll. 4-13. Dr. Loube makes the same points at pages 33-34 of his Direct Testimony.

⁷¹ *Brevitz Direct*, p. 87, ll. 4-6.

⁷² The financial model projects that, starting in 2008, the balances for shareholders equity will decline [BEGIN CONFIDENTIAL] [REDACTED] [END CONFIDENTIAL] *Brevitz Direct*, p. 87, ll. 9-11.

⁷³ According to its Form S-4A filing to the SEC, FairPoint “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.” *Brevitz Direct*, p. 88, ll. 12-17.

⁷⁴ *Brevitz Direct*, p. 89, ll. 1-12.

necessary to make such calculations.⁷⁵ Because FairPoint does not know the condition of the NNE operating plant in any detail, the results of its financial model are based on an unrealistic and un-informed estimate of capital expenditures.⁷⁶

In short, FairPoint's financial model is (inappropriately) based on Verizon's recent level of capital expenditures. Because Verizon has had recurring service-quality problems during the period covered by those capital expenditures, the Commission should assume that the model's estimate of future capital expenditures understates the level of expenditures that FairPoint would have to undertake. That is particularly true because FairPoint has firm plans to increase the provision of DSL in outlying NNE areas. By its very nature, the effort to extend DSL will also expose any weaknesses in the operating plant, thereby resulting in additional capital expenditures. Hence, the financial model is flawed; it understates capital expenditures.

**** Inaccurate Calculation of High-Cost Support.** The amount of high-cost support that the FairPoint NNE entity would receive varies by study area. For example, Maine receives \$0.22, New Hampshire receives \$0.0, and Vermont receives \$1.98, per line per month. FairPoint's model fails to account for those differences. A more accurate estimate of the high-cost monies that FairPoint would receive could be calculated by forecasting each state's line count separately, and then multiplying each state's number of supported lines by each state's amount of support.⁷⁷

**** Model Does Not Adjust for Impact of Cable Competition.** Built into FairPoint's model is the assumption that FairPoint's DSL build-out would allow it to retain more customers. The model assumes that reductions in its local exchange customers will be offset by increases in UNE-Loops sales.⁷⁸ However, the analysis of most participants in the market -- and of most analysts -- is that the cable TV company will be the most significant competitor in the Maine telephone market.⁷⁹

⁷⁵ Id.

⁷⁶ Indeed, in one of its Hart/Scott/Rodino documents, FairPoint's senior management acknowledged the risk of unplanned capital expenditures that exists because FairPoint does not know the condition of the NNE operating plant. FairPoint acknowledged a "challenge" regarding [BEGIN CONFIDENTIAL] [END CONFIDENTIAL] *Brevitz Direct*, p. 60, ll.13-15; OPA Exhibit #112(FairPoint HSR Documents, Attachment 4(c)-11, at page 1). The FairPoint financial model simply [BEGIN CONFIDENTIAL] [END CONFIDENTIAL]

[END CONFIDENTIAL] *Brevitz, Direct*, p. 60, ll.16.19.

⁷⁷ Loube Direct, p. 30, ll. 9-20.

⁷⁸ Loube Direct, p. 35, ll. 13-15.

⁷⁹ Id, p. 35, ll.18-22.

Furthermore, FairPoint does not appear to have a coherent, well-thought-out plan for the offering of video services. At hearing, FairPoint (Mr. Nixon) did not know what costs or effort would be necessary to offer video service. If the Commission contrasts FairPoint's lack of readiness to provide video services with the observation by Standard & Poor's⁸⁰ that video is the "most potent" weapon to address cable competition, the Commission can see that FairPoint NNE will be vulnerable to competition from cable telephony. That means that when FairPoint loses a local customer to a cable company, there will be no offsetting revenue from the purchase of a UNE-Loop. In other words, the model overstates the amounts of the UNE-Loop revenue that FairPoint NNE would receive in the 2008-2012 period.

**** Model Makes Flawed Assumption about Effect of Increasing DSL Availability.** FairPoint's financial model is based its strategy of increasing DSL capability as an important means to moderate its retail line losses. FairPoint assumes that by increasing the availability of DSL services, it can limit the continuing losses of its local exchange customers. However, the linear regression analysis performed by Dr. Loube shows that, in actual experience, increasing DSL capability has not been an effective tool in limiting the loss of telephone customers to the cable company.⁸¹ As a result, the assumptions contained in the financial model overstate the amounts of local revenues that FairPoint NNE would receive over the next four years.

**** Unrealistic Assumption Regarding Employee Levels.** FairPoint's financial model calculates the labor costs for the combined FairPoint entity based on FairPoint's unrealistic assumption that there will be an annual 4% attrition in FairPoint's workforce. FairPoint derived that 4% figure simply by assuming that the 4% attrition rate experienced recently by Verizon would continue. *10/3/07 Tr. 101, ll. 10-16.*

**** Model Does Not Adjust For \$12 Million Reduction to FairPoint's Working Capital.** After FairPoint had constructed its model, FairPoint and Verizon adopted an amendment that restructured the terms of the proposed transaction. Verizon agreed to invest an additional \$12 million in capital expenditures (for DSL deployment) prior to year-end 2007. In turn, FairPoint agreed to reimburse Verizon for that \$12 million amount with the result that the working capital amount that Verizon would pay to FairPoint was reduced by \$12 million. The model fails to capture that adjustment.

⁸⁰ See text above associated with footnote 22

⁸¹ Loube Direct, pp. 37-38. Dr. Loube's theory is that when telephone customers subscribe to DSL service, they will quite often substitute that service for the second line that they had used for internet access. Hence, FairPoint's plans to increase DSL availability may result in further loss of exchange lines.

J. The Financial Model Fails to Adjust For a Number of Contingencies That Would Have Adverse Impact on FairPoint’s Financial Condition.

FairPoint’s financial model has other shortcomings also. The model fails to account for the various forms of risk that the FairPoint NNE company would face. Given the nature of the proposed transaction, there a number of contingencies can easily disrupt FairPoint’s model and its projections. For instance, consider the following possibilities:

**** Synergies Do Not Occur As Projected.** FairPoint’s management claims that, within a year after closing, the new FairPoint NNE company will be able to improve its cash flow by achieving \$60 to \$75 million per year in merger savings. However, those savings are only an assumption based on FairPoint’s expectation that it can achieve “synergies” by building it’s on manage and support systems to replace the systems now provided by Verizon. FairPoint’s calculation of its projected savings is based on the difference between two separate estimates: the allocations that Verizon has made to the NNE properties and FairPoint’s estimate of the incremental expenses it will incur to operate the NNE entity.⁸² Realization of the asserted synergies depends on the extent to which Verizon’s allocation estimates have been correct, and on the extent to which FairPoint’s estimated direct costs will materialize as projected.

FairPoint’s financial model does not adjust for the possibilities that only portions of the synergy savings may occur. Indeed, with respect to synergies, the model’s calculation appears to be “circular.” That is, one of its underlying inputs is the full amount of the synergy savings, and, in turn, the model suggests -- no surprise here! -- that the synergy savings will be achieved.⁸³ Indeed, to some extent, FairPoint’s estimate of synergy savings reflects the same goals as the financial model. The synergies estimate is part of management’s effort to “sell” the proposed transaction -- both to the investment community, and to the regulators who must approve the transaction.

⁸² OPA Exhibit # FairPoint projects “synergy” savings that are the difference between the costs that Verizon has historically allocated to the NNE properties – i.e., expenses that will be eliminated upon closing -- and the incremental direct expenses that FairPoint would incur post-closing in areas such as engineering, operations, finance and accounting. FairPoint estimates that the net of the eliminated allocations and increased direct costs will be approximately \$60 to \$75 million, assuming a successful integration of FairPoint NNE. *Brevitz Direct*, p. 56, ll. 12-25.

⁸³ In its financial modeling, FairPoint did perform one “Material Adverse Change” scenario that was designed essentially to assume that no synergies occurred. That scenario shows that, with no synergy effect, [BEGIN CONFIDENTIAL] [REDACTED] [END CONFIDENTIAL] *Brevitz Direct*, p. 58, ll.4-11. That scenario suggests that the financial success of the transaction depends, in part, on full achievement of the estimated synergy savings – which, in turn, suggests that the proposed transaction is pretty risky.

There is a substantial risk, of course, that the anticipated “synergy” savings will not be attained. For instance, those savings will be eliminated if the annual operating expenses for FairPoint NNE increase at rate faster than FairPoint has assumed in the model. The risk that there will be no savings is heightened by the fact that the proposed transaction is a complete shift of business method for FairPoint. That is, FairPoint faces a level of “integration risk” much higher than it faced in prior acquisitions.

Finally, here again the model projections are affected by a crucial FairPoint assumption—that the number of employees will decline by 4% or more annually. *10/3/07 Tr. 101, ll. 10-16*. Evidently FairPoint simply assumed a continuation of employee trends from Verizon’s past history of operating the business, and made no inquiry as to whether it is reasonable to assume that such trends would continue. FairPoint did not research whether the 4% decline was a normal, ongoing trend, or whether it might be substantially influenced by “buyout” force reduction plans. Labor costs are a very substantial operating expense. In the face of declining service quality FairPoint may find that its assumption that the old Verizon trend would continue may prove to be substantially in error. If FairPoint is forced to address those service-quality problems that error would “chew up” good portions of any synergy savings. All other things equal, the actual financial results would more closely resemble the “MAC” case (see footnote 75, above) than FairPoint’s projection. Hence, there are good reasons to question whether the synergy savings can be achieved.

**** Integration of FairPoint NNE Does Not Occur As Planed.** In its past acquisitions, FairPoint was able to achieve savings simply by eliminating unnecessary expenses, primarily duplicative and expensive upper management functions, thereby making existing operations appear to be more efficient.⁸⁴ (It is not clear whether this comparative view is taken before management services allocations from FairPoint affiliates, or after.) In this proposed transaction FairPoint faces a more substantial and entirely different challenge compared to previous acquisitions, which means that its integration risk is substantially higher. FairPoint is proposing to acquire a large geographic operation that currently depends on a centralized management located outside its area of operations. That centralized management will be eliminated, and FairPoint will be forced to design develop, integrate and implement new and complete systems that will manage the company and provide operational systems support in all three states.⁸⁵ In

⁸⁴ For example, here in Maine when FairPoint acquired Utilities Inc., it worked to cut operating costs. However, the costs that were eliminated did not result from creating a new, more efficient set of management systems. Instead, the three largest expenses reduced by FairPoint after the acquisition were (1) the elimination of in-house systems development, (2) the elimination of the President & CEO position, and (3) the elimination of the marketing-department head position. *FairPoint’s Response to ODR-OPA-6*.

⁸⁵ Brevitz Direct, pp. 61-62. There are numerous unknowns regarding the development of back office systems including the length of time to develop, the cost to develop, training and productivity of employees with the newly developed systems, the extent to which existing Verizon data will be able to be managed effectively and in integrated fashion on the new systems, the extent to which developed systems effectively replicate or improve upon

addition, those systems must function properly together in order to provide all aspects of telco operations that have been operated by Verizon in an integrated fashion. There is no “off the shelf” integrated system for this. Verizon had a period of more than fifty years to develop its systems; FairPoint must develop 600 new systems in a period of approximately ten months.⁸⁶ FairPoint may find that it has underestimated the complexity, cost and time for the task. That is, FairPoint may face increases in the time and money⁸⁷ necessary to integrate the new systems necessary to operate its NNE entity.

In addition, FairPoint may find that it is forced to make additional payments to Verizon during the transition. If FairPoint continues to require services from Verizon after the one-year anniversary of the closing of the merger, the fees payable to Verizon under the transition services agreement (TSA) will increase significantly.⁸⁸ Under the TSA, the aggregate fees expected to be paid to Verizon for the six-month period following the merger would be approximately \$132.9 million. However, if FairPoint NNE requires twelve months of transition services following the merger, the aggregate fees that FairPoint will pay to Verizon will be approximately \$226.9 million – an increase of \$94 million. Such an increase would more than eliminate any merger synergies.

**** Post-Closing Competition by Verizon.** There are no restrictions on Verizon’s ability to compete with FairPoint NNE following the merger.⁸⁹ Verizon will retain its Enterprise customers and the former-MCI operations that will still serve its NNE business customers. Verizon also has the customer knowledge derived from those businesses, and will be able to compete with FairPoint in the NNE areas. Verizon has informed FairPoint of its intent to compete with FairPoint by continuing to provide the following services⁹⁰ in the NNE territories:

existing Verizon systems, and the extent to which FairPoint will be able to effectively develop and operate systems in areas where it has no previous experience (e.g., CLEC and wholesale services). *Brevitz Direct*, p.52, ll. 8-15. FairPoint’s financial model does not adjust for the increased costs to FairPoint if any of its new systems are not 100% operable at cutover.

⁸⁶ *Brevitz Direct*, p. 50, ll. 30-28, quoting from FairPoint’s Form S-4A

⁸⁷ As an example, FairPoint has already experienced one such increase in costs. It was forced to terminate its original contract for the development and implementation of a NNE billing system. Since then, it has changed vendors and signed Capgemini to develop the new billing system.

⁸⁸ Under the TSA, the aggregate fees expected to be paid to Verizon for the six-month period following the merger would be approximately \$132.9 million. However, if FairPoint NNE requires twelve months of transition services following the merger, the aggregate fees that FairPoint will pay to Verizon will be approximately \$226.9 million. *Brevitz Direct*, p. 50, ll. 18-28, citing to FairPoint’s Form S-4A filing.

⁸⁹ *Brevitz Direct*, p. 67, ll.1-3, citing FairPoint Form S-4A, July 2, 2007, at page 106.

⁹⁰ *Brevitz Direct*, p.65. ll. 14-27; also see: *Brevitz Direct*, pp. 66-67.

- ** long distance services, prepaid card services, and the resale of local exchange service;
- ** wireless voice, wireless data & other wireless services including VOIP services;⁹¹
- ** carrier services, data customer premises equipment & software, call center solutions, and the products and services formerly offered by MCI.

However, FairPoint's financial model fails to account for the competitive impact that any of Verizon's activities in the NNE market will have on FairPoint, post closing.⁹²

One particular line of business where competition by Verizon will impact FairPoint's financial projections is in the model's assumption regarding FairPoint's Enterprise Revenue. There FairPoint "assumed total average revenue per unit for the Spinco business would increase 26% versus 2006 levels by 2012 as the Spinco business captured a greater percentage of the overall spending by Enterprise customers."⁹³ However, it is more likely that, over time, Verizon will seek to sell all services to Enterprise accounts, rather than sharing with FairPoint. Also, FairPoint's lack of historical experience with Enterprise level customers would make it much more difficult to retain those customers and revenues. The financial model fails to adjust for that likelihood.

**** Labor Disputes or Other Labor Difficulties.** If the merger occurs, approximately 67% of the combined company's employees will be members of unions. The two principal collective bargaining agreements with those unions expire in August 2008.⁹⁴ At the expiration of those agreements, FairPoint may not be able to negotiate new agreements on favorable terms. Or the unions may strike. The model fails to account for the possibility that, post closing, FairPoint will not be able to resolve its labor relations issues. Labor disruptions would reduce the combined company's sales and increase its costs, impairing its operations and weakening its financial condition.

**** Employee Pensions or Other Post-Employment Benefits.** The model makes the (inappropriate) assumption that, post closing, FairPoint will [BEGIN CONFIDENTIAL] [REDACTED]

⁹¹ Direct Testimony of Stephen E. Smith, p. 20.

⁹² Brevitz Direct, pp. 67-68.

⁹³ Brevitz Direct, p. 68, citing FairPoint Communications 7/10/07 Form S-4A, at page 80.

⁹⁴ Brevitz Direct, p.69-70.

[REDACTED]
[END CONFIDENTIAL]⁹⁵

Ultimately, FairPoint has presented its financial model in this proceeding in an effort to demonstrate that, after the proposed transaction, the FairPoint would have sufficient “free cash flow”⁹⁶ to cover its obligations. That is, Fair Point claims that its financial model shows that the combined FairPoint company would be financially viable – i.e., that the combined FairPoint company would generate a cash flow greater than the amount necessary to cover its planned network investment, operating expenses, taxes, all debt service, and dividends to stockholders?⁹⁷ However, for the reasons stated in the above sections, the Commission should not rely on the bare outputs of the financial model as support for this proposition, because the model results are demonstrably unreliable.

Therefore, the Commission should not place any reliance on FairPoint’s projected financial results as a demonstration of financial viability of the proposed combined company. There is a good chance that FairPoint’s financial projections will prove to be inaccurate, resulting in financial distress for FairPoint. As a “high debt/high dividend” company, FairPoint would be in a poor position to deal with any significant adversity that would result from exposure to events and circumstances not contemplated in FairPoint’s financial model. In short, FairPoint’s risky financial structure exposes it (and its customers) to [misfortune] in the event if any of the following events should occur:

- increasing interest rates,
- line losses due to competition (especially competition from cable telephone service),

⁹⁵ Brevitz Direct, p.70, ll. 11-13.

⁹⁶ “free cash flow” – i.e., cash available after payment of dividends and all other cash obligations.
Brevitz Direct, p. 90, ll. 2-3.

⁹⁷ Brevitz Direct, p. 90, ll. 3-8, citing *FairPoint Communications, Form 425, filed June 21, 2007*.

- changes in the financial markets such that “high yield” or “junk bond” debt can no longer be obtained at historically low margins over safer investments,
- changes in the financial markets such that “high yield” rural LECs are no longer favored in the marketplace,
- greater than expected capital expenditures to rectify service-quality problems not known in detail until after closing,
- a slower than projected pace of revenue gain (i.e., in DSL), caused by difficulties in facilities quality or by capacity-of-service difficulties,
- operating expenses increase at rates faster than the zero percent growth forecast by FairPoint’s model,
- failure of other line item projections to come in at projected levels in actuality, e.g., the CLEC business,
- failure to achieve the overall savings expected compared to Verizon costs (“synergies”),
- work stoppages (or slow-downs) from labor disputes, and
- cost, time and functionality difficulties in developing, integrating and installing interrelated “back office” operating systems (for example, the recent Capgemini Work Order #2),

K. The Per-Line Value of the Transaction Is Not “Low” in Comparison With Previous Transactions.

At hearing, FairPoint suggested that Verizon has agreed to sell its NNE properties at a price per-line that is well below the price per-line in previous RBOC sales. FairPoint argues that it will be benefiting from a sale at a low price per line, and suggests that the sale price will give the company the flexibility to invest in the NNE network.⁹⁸ (FairPoint also seems to be suggesting also that Maine and Maine telephone customers will be benefiting from that lower

⁹⁸ FairPoint’s claim that the low per-line price will give the company the flexibility to invest is belied by its financial model and related evidence that shows that FairPoint will not have sufficient cash flow to meet the combined requirements of interest and principal payment on debt, dividends, capital expenditures, operating expenses and taxes. Furthermore, despite the service-quality deterioration that has occurred over recent years, in the model FairPoint projects to spend essentially the same level on capital expenditures as did Verizon, and to continue the 4%, or greater, annual decline in employee levels experienced by Verizon.

price, although it is not clear why. FairPoint has not suggested that it will lower telephone rates for NNE customers because it is paying less per line.)

FairPoint's attempt to "sell" the proposed transaction on the grounds that the low per-line price confirms that it is getting "good deal" overlooks several distinguishing facts. First, there is a good reason why the sale price is low. The price for the NNE exchanges is low because, in effect, FairPoint is buying "a car without the engine." That is, FairPoint is purchasing Verizon's NNE properties, but is not receiving the hundreds of management systems and support systems that are required to provide telephone service in those territories. FairPoint is not buying a "turn-key" operation. Instead, 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. FairPoint attempts to suggest elsewhere that other transactions disposing of wireline operations have not included the transfer of back-office systems. This is misleading to the Commission. In a series of eight Verizon access-line dispositions between 2000 and 2002, all but two acquirers were a larger ILEC that already operated then-existing back office systems. The acquiring company was thus able to add the new access-line operations to its existing back-office operations. That type of acquisition was entirely different from the circumstances here where FairPoint must design, develop and integrate the entire panoply of back-office systems in order to develop the infrastructure necessary to operate the acquired operations. One exception was Iowa Networks, which acquired a relatively small number of access lines in a single state. Verizon was not the primary ILEC in Iowa, as it is in Maine. The second exception is Valor Telecom, which acquired Verizon operations in three states, but "outsourced" the back office functions to Alltel. Valor used Alltel in a "service bureau" manner to obtain its back-office

functions, and did not undertake the task of replicating Verizon's back-office systems. The only subsequent Verizon disposition after this period was Hawaiian Telecom, which was sold without back-office systems to a party that did not already possess such systems for other operations. The negative results have been well documented both in this record and elsewhere.

Second, FairPoint's claim overlooks the fact that, as proposed, the Verizon/FairPoint transaction is a tax-free transaction, a circumstance that has a material impact on the per-line price for the NNE properties. The sales of other telephone companies were not comparable because those transactions were taxable sales, and as a result, the per-line price was driven up by the required tax payment. Third, FairPoint's arguments also overlook the fact that the earlier sales took place at a point when there was a very different market for telephone companies, and dramatic annual losses of access lines were yet to occur. The full impact of ILEC provision of UNE-P had not been realized. Many ILECs were in fact fighting the requirement to provide UNE-P at that time. Further, cable telephony was only forecast at that time in most, if not all, areas. Therefore, at the time of those sales, the numbers of access lines were either stable, or on the increase. By contrast, FairPoint is buying the NNE properties at a time (a) when they have experienced dramatic losses of access lines, and (b) when those companies face further access-line loss due to increasing competition by the cable companies. The market has been making the judgment that the wireline telephone business may not be so profitable as it has been, and therefore the per-line price of telephone companies has dropped.

Finally, we note that the per-line price that FairPoint is paying in the proposed transaction is comparable to the per-line price paid The Carlyle Group when it purchased Verizon's Hawaii property. The fact that the per-line prices for those two transactions are comparable is not a good sign. That is because the Hawaii transaction – with its comparable per-line price – has resulted

in extremely serious problems involving the development of “back office” systems. We do not want to see that type of development replicated here with the FairPoint NNE entity. Also, the sale of the Hawaii exchanges was a taxable transaction, and therefore the per-line price for the “non-taxable” sale to FairPoint should be notably smaller. When taxes are factored in to the comparison, the price per access line of the proposed NNE transaction would be generally equivalent to the Hawaiian Telecom (HT) transaction. The degradation of service currently experienced by HT customers indicates that purchase price was probably too high. Similarly, the integration and other risks associated with this proposed transaction suggest that the purchase price here is too high. That is further confirmed by Verizon’s own analysis as presented to its Board of Directors.

Verizon performed an analysis designed to separate the valuation of its wireless business from the valuation of its wireline business. This analysis indicated that, based on the Verizon stock price at that time, its wireline business had an [BEGIN CONFIDENTIAL] [REDACTED] [REDACTED] [END CONFIDENTIAL]⁹⁹ Comparison of that EBITDA multiple to the proposed NNE transaction multiple of 5.6x 2007 EBITDA shows the extent to which FairPoint is overpaying for the NNE wireline business compared to the market’s judgment as to what that wireline business is worth.

1. Verizon’s Own Internal Analysis Demonstrates Sale Price Is At Upper End of Valuations

Verizon’s own analysis demonstrates that the transaction valuation of \$2.715 billion is at the upper end of valuations. The Public Advocate submits that this analysis proves that the transaction price is too high, particularly for “a car without the engine”. None of the valuation

⁹⁹ Verizon HSR documents, January 15, 2007 Merrill Lynch Presentation to Board, page 29.

methodologies account for the fact that Verizon is disposing of its NNE properties to a buyer who does not already have back office systems already in the hands of the buyer.

Verizon's valuation materials demonstrate that the upper end of valuation estimates is

[BEGIN HIGHLY CONFIDENTIAL] [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] [END HIGHLY CONFIDENTIAL]

Furthermore, the same document demonstrates that the proposed transaction price is well above [BEGIN HIGHLY CONFIDENTIAL] [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] [END HIGHLY CONFIDENTIAL]

Verizon's own data and analysis support Mr. Brevitz's statement at hearing that Verizon is charging FairPoint too much for the transaction, even though FairPoint has agreed to it. In effect, FairPoint has agreed to a "bad deal".¹⁰¹ The fact that the transaction is for "a car without the engine" greatly exacerbates this "bad deal". The Public Advocate's recommendation that the amount of debt proposed for FairPoint be reduced by \$600 million serves to bring the proposed transaction to a place that ameliorates the considerations above, but still results in

¹⁰⁰ OPA # 94 Verizon HSR documents, "Confidential Presentation Materials prepared for the Verizon Board of Directors Regarding Project Noreaster", Merrill Lynch, January 15, 2007, page 13.

¹⁰¹ CITE, Transcript, Brevitz, xxx.

proceeds to Verizon [BEGIN HIGHLY CONFIDENTIAL] [REDACTED]

[REDACTED] END

HIGHLY CONFIDENTIAL]

2. If the Transaction is Approved, FairPoint Should be Subject to Close Financial Monitoring by the Commission.

In the course of this proceeding, FairPoint has provided its financial projections to the Commission and has stated that it will meet or exceed those projections. If the proposed transaction is approved, the Commission should take steps to ensure that FairPoint is able to adhere to its projections. Furthermore, the Commission should require that FairPoint identify and explain any material differences that occur between its projections and its actual experience. Given the “high debt/high dividend” nature of FairPoint’s proposed financial structure, must be able to monitor the financial viability of the new FairPoint during the first three to five years of its existence. If negative financial changes occur, the Commission must be in a position where it has sufficient information to intervene, if necessary, to address any financial distress that threatens FairPoint’s ability to deliver utility services. FairPoint should be subject to close financial monitoring by the PUC, including the following special reporting requirements:

- 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.)

3. The Proposed Transaction is Much More Risky Than Other Recent Spin-offs

Joint Applicants seek to paint the picture that the proposed transaction is “like” the recent Alltel and Sprint Nextel spin-offs, which have been approved, implying that therefore this transaction should be approved as well. Despite some similarities, this is patent exaggeration. Both the Sprint Nextel spin off leading to the formation of Embarq, and the Alltel spin off and merger creating Windstream were tax free transactions which placed substantial debt on the newly created entity. The Embarq spin off was tax free, while the Windstream transaction was tax free and in the form of a Reverse Morris Trust. The proposed transaction is also proposed to be a tax free spin off in the form of a Reverse Morris Trust. Beneath these similarities, however, substantial differences exist such that analogy to the previous transactions provides no justification for approval of the proposed transaction.

Beyond the general similarities outlined above, the Embarq spin off is not substantially similar to this proposed transaction for the following reasons:

- The Sprint Local Telecommunications Division which was spun off from Sprint Nextel was a fully functioning autonomous division;
- Sprint LTD was spun off with all management and back office systems intact and functioning;

- Embarq did not need to develop, replicate and integrate back office systems in connection with the spin off;
- Embarq was spun off able to achieve investment grade bond ratings due to regulatory conditions associated with the transaction's approval. Sprint Nextel committed to the FCC that the company will be a financially secure Fortune 500 company in order to ensure that customers continue to see a high level of service and investment in advanced services;
- Thus, at the time of the spin off, Embarq's Debt/EBITDA was approximately 2.5x (in contrast to the 4.3x inherent in the FRP financial projections);
- Embarq is financially strong enough that it was able to substantially pay down debt "immediately" following spin off, such that current Debt/EBITDA is 2.3x.

Beyond the general similarities outlined above, the Alltel spin off and merger creating Windstream is not substantially similar to this proposed transaction for the following reasons:

- The Alltel Local Telecommunications Division which was spun off from Alltel was a fully functioning autonomous division;
- Alltel LTD was spun off with all management and back office systems intact and functioning;
- Windstream did not need to develop, replicate and integrate back office systems in connection with the spin off;
- Valor Telecommunications contracted with Alltel for the provision of back office systems, and had been receiving such services for years prior to the transaction. Thus Alltel LTD and Valor were already integrated and obtaining back office functions from the same systems;
- No risks of integration of the acquired company into the acquiring company existed due to the fact that back office functions were already integrated;
- No material synergy savings were foreseen by analysts;
- The split between Alltel/Valor shareholders was 85/15, compared to 60/40 for the proposed transaction. This large difference reflected the fact that Valor Telecom was in substantial financial difficulty due to its high leverage, and that Alltel LTD would be in total management control of the new entity;
- No Valor senior management was retained, all senior management positions were filled by either existing Alltel LTD managers or outside hiring (Chief Operating Officer);

- Windstream's Debt/EBITDA was targeted to be approximately 3.5x (in contrast to the 4.3x inherent in the FRP financial projections);
- Windstream has since reduced that ratio to approximately 3.2x.

Mr. Brevitz also testified on the Windstream matter in Kentucky, and his analysis has proved substantially correct: Alltel LTD was spun off and burdened with substantial debt in order to de-leverage Alltel wireless in preparation for a later sale. Alltel Wireless is now in the process of being acquired by a private equity firm. *See, Brevitz Direct at 31-34, TR Oct. 5 at 61-83 and Valor S-4 SEC filing (administrative notice).*

V. SERVICE QUALITY -- THE COMMISSION SHOULD APPROVE THE PROPOSED TRANSACTION ONLY UPON THE CONDITION THAT FAIRPOINT IS SUBJECT TO AN ENHANCED SERVICE QUALITY PROGRAM AS RECOMMENDED BY OPA WITNESS, BARBARA ALEXANDER

A. Introduction

This proceeding will require the Commission to consider an array of risks and potential benefits for the Maine customers of Verizon Maine, particularly those who depend on basic local exchange telephone service to meet their telecommunications needs. While FairPoint has emphasized the potential rewards, it has failed to identify and respond properly to the significant risks associated with its purchase of such a substantial telecommunication network. FairPoint's testimony also falls short in addressing the company's obligation to provide high quality local exchange telephone service to the 1.6 million customers that it will be serving. FairPoint has promised "improved" service quality and has promised to meet the obligations currently imposed on Verizon through its currently applicable SQL. However, FairPoint has not agreed to transfer the risks of failing to meet these obligations, from the customers it will inherit from Verizon to its own shareholders. The Public Advocate recommends that, if the Commission approves this

transaction, the Commission impose on FairPoint specific and enforceable service quality and customer service conditions that will transfer those risks from customers to FairPoint's owners and managers.

In her Direct and Surrebuttal testimony, Public Advocate witness Barbara Alexander did not express any opinion as to whether the Joint Petition should be approved, but she made five general service quality-related recommendations that should be imposed as conditions on FairPoint in the event that the Joint Petition is approved. 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 penalties¹⁰²;
- 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 the FairPoint billing systems for both its new Verizon and classic FairPoint customers have been clearly identified; and
- A requirement that FairPoint 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 service quality index (SQI) designed for FairPoint must reflect not only the risks associated with this particular merger, but it must also take into account the "poor service

¹⁰² In her Surrebuttal testimony, Ms. Alexander responded to FairPoint's recognition of the need for significant improvement in certain network operation metrics, particularly the Percent Troubles Not Cleared with 24 Hours (Residential) and the Customer Trouble Report Rate, and its pledge to submit a specific compliance plan to obtain compliance with the current standards within two years. Ms. Alexander recommended that the penalties applicable to FairPoint for the failure to comply with its forthcoming compliance plan be set so as to link penalty dollars with this gradual improvement and hold in abeyance any escalation in the overall penalty structure for this two-year period. *See Alexander Surrebutal at 4.*

quality”¹⁰³ that FairPoint will inherit from Verizon-Maine. The details of the current Verizon SQI and Verizon’s performance with these service quality performance standards are set out in Barbara Alexander’s Direct Testimony. See: Alexander Direct at 31-34. The Commission, of course, may take administrative notice of the recent poor performance of Verizon and of the annual SQI penalties it has paid since the year 2000. It is essential that FairPoint be required to implement a specific service plan that will make available resources that are to improve on the inadequate levels of service quality that Verizon has delivered in recent years.¹⁰⁴

B. The Commission Should Impose on FairPoint Specific Conditions That Address The Additional Service-Quality Risks That Will Exist if The Joint Petition is Approved

If the Joint Petition were to be granted, the Commission would be faced with a new set of risks that may affect service quality in a different way. Prior Maine Commission decisions on service quality have focused on the tendency of utilities to cut costs when under an AFOR, or on the probability that a competitive market might have a negative effect on service quality. Now, however, the prospect of FairPoint’s ownership of Maine’s dominant network creates some additional concerns. For example, as FairPoint itself agrees, FairPoint’s cutover to its own new billing and operational systems presents substantial risks. When asked about the risks set out in FairPoint’s S-4 filing with the Securities and Exchange Commission,¹⁰⁵ FairPoint’s president,

¹⁰³ Docket # 2005-155 Examiner’s Report at 228.

¹⁰⁴ The Commission and the parties recently invested substantial resources in developing a new service quality plan that might apply to Verizon for the next AFOR term. In Docket No. 2005-155, the Examiners determined an appropriate independent service quality program (SQI) including specific metrics and penalties, to be applied immediately, even before determining whether a new AFOR would be ordered. The Commission Staff took this definitive step explicitly to address “Verizon’s increasingly poor service quality”.¹⁰⁴ The Staff further stated:

We find that Verizon’s poor performance, whether due to cost-savings incentives of the AFOR or other reasons, is sufficient justification to continue to monitor its service quality

¹⁰⁵ See Alexander Direct at 12-13.

Peter Nixon, candidly acknowledged that those risks still remain. *TR Oct. 10 at 319*. Although the S-4 filing is intended principally to disclose investor risks, the risks identified in the S-4 filing may also harm customers, unless the Commission imposes conditions on FairPoint that are effective in insulating customers. The Commission should understand that, in effect, Maine's ratepayers -- and even the Commission itself -- are also "investors" in the proposed transaction. By virtue of its statutory responsibility to ensure adequate utility service, the Commission has a crucial stake in the success of the proposed transaction. For that reason, the Commission must also consider the negative consequences to customers of the various risks identified in FairPoint's S-4 filing.

In her testimony Barbara Alexander identifies several reasons why the Commission should be concerned that, if FairPoint provides service, there is a risk of further deterioration in service quality. *Alexander Direct at 8-11*. Some, but not all, of those concerns are related to the inherent risk that serious problems will occur when cutting over to new billing and operational systems. Other concerns arise, based on new factors introduced by FairPoint itself.

1. Achieving Efficiencies at the Expense of Service Quality

For example, FairPoint's stated goal of creating substantial operating efficiencies of \$60 to \$75¹⁰⁶ million compared to Verizon, may set in motion internal pressure to achieve these savings at the expense of investment in network reliability, maintenance of service, and customer care expenses at the call centers¹⁰⁷. Under cross-examination, when Mr. Leach was asked whether he has committed to use any portions of those savings to improve customer service, he replied "we have not". *TR Oct. 3 at 52*. Given the specifically identified service quality

¹⁰⁶ *Leach Rebuttal at 46*.

¹⁰⁷ *See also, Leach Rebuttal at 47-52*.

performance issues that FairPoint would inherit, it is surprising that FairPoint, as of the date of the hearings, would not already have a plan to use identified cost savings to address those issues.

2. Risks Presented by Labor Issues

While Ms. Alexander focused on the employment-related risks presented by excessive early termination, hiring delays and training issues that might negatively affect FairPoint's ability to deliver good service quality, the Public Advocate has additional concerns relating to FairPoint's general labor-relations problems. The IBEW and CWA have made it clear that, for a variety of reasons, FairPoint would be starting off with a poor relationship with its new work force. Undoubtedly, FairPoint cannot succeed, especially with respect to improved service quality without relying on CWA and IBEW members. Whether or not FairPoint is to blame for this poor relationship, the risk it creates must be recognized. These risks include excessive attrition of the Verizon labor force, challenges in recruiting and training¹⁰⁸ new employees, and even strikes¹⁰⁹.

This poor relationship, if not the fault of FairPoint, may nonetheless be related to FairPoint's characteristics. Its financial viability, its small size, and its history of non-union labor forces in its other operations are all factors that have caused the IBEW and CWA to be highly skeptical of this new employer. Service quality is clearly dependent on a well-trained, well motivated, fully staffed labor force.

At the hearing, FairPoint made it clear that FairPoint's employees will be responsible for performing repairs even before cutover as well as for staffing the new repair center and dispatching repairs after cutover. *TR Oct. 10 at 147-148*. This labor transition presents

¹⁰⁸ FairPoint witness Haga acknowledged that a new systems training plan for employees has not yet been completed. *TR Oct. 10 at 146*.

¹⁰⁹ See also Brevitz Direct at pages 32-33 and 70.

substantial risks, especially given that FairPoint has not completed development of a training plan.¹¹⁰

3. Risks to Service Quality Based on FairPoint's Admitted Focus on Unregulated Services and Its Insufficient Focus on Traditional Voice Service.

Despite the benefits of greater DSL deployment, which the Public Advocate has encouraged and focused on more than any other party in this proceeding, the Commission should always keep that benefit in perspective. For example, the DSL investments will have the result of enhancing FairPoint's unregulated interstate revenues but this goal could compete with FairPoint's obligation to comply with its statutory and regulated directive in Maine to provide affordable basic telephone service to all its customers. DSL services, while welcome, are no substitute for this Commission's obligation to assure that basic local exchange service is provided with a reasonable level of service quality.

Assurance of good service quality is one of the core jurisdictional obligations of the Commission and service quality performance will affect a much larger segment of the population than will FairPoint's DSL expansion¹¹¹. For that reason, investment in *unregulated* services should always be at the risk of shareholders who *voluntarily* take those risks. The Commission should guard against the risk that unregulated investments will compete with service quality and customer service for limited resources. In addition to DSL investment, FairPoint's plans to enter the video business may have similarly distracting effects upon voice service quality.

¹¹⁰ As of the time of the hearings, FP's training plan was still in draft form. *Tr. Oct. 10 at 146*. Furthermore, Mr. Nixon on behalf of FP acknowledged that FP has never undertaken a training program of this size or scope. *Tr. Oct. 10, at 243*.

¹¹¹ Large segments of Maine's customer population, especially among the elderly, do not use the Internet at all. Of those who do use the Internet, large percentages of that population would continue to use dial-up service, cable-modem service, or one of several new types of wireless broadband service. DSL is just one technology for access to the Internet and technology is always changing.

In comparison to FairPoint's prospective DSL market share, the incumbent market share of local exchange telephone service remains extraordinarily high. Indeed, that market share of traditional telephone customers represents far more people than those who would actually subscribe to FairPoint's DSL service, even under the most optimistic assumptions about FairPoint's DSL take-rate and deployment. Therefore, potential consequences to service quality and rates for traditional telephone service should remain the primary focus of the Commission, especially if it may not be the primary focus of FairPoint. The Commission should be particularly cognizant of any attempt to subsidize unregulated DSL service at the expense of regulated telephone service by failing to fully correct the current imbalance between cost and revenue jurisdictional allocations. Such subsidies can diminish regulated resources that would tend to support a reasonable level of service quality.

FairPoint has already exhibited its tendency to focus less on service quality of traditional voice service than on its plans for deployment of unregulated services. As pointed out by Barbara Alexander:

It does not appear that FAIRPOINT has yet obtained a good working knowledge of Verizon Maine's service quality performance. FAIRPOINT has not undertaken any detailed analysis of the actual performance data or what it would take to assure future compliance.

Alexander Direct at 29. This view is corroborated by FairPoint's Response of vague promises on the subject of service quality. It has indicated a willingness to improve performance where Verizon has performed poorly but has failed to develop a specific plan or to allocate a specific budget to accomplish remediation of service quality problems.

4. Risks From New Billing and Operational Systems

Cutover risks are obvious and, as demonstrated earlier, are fully acknowledged by FairPoint, both in its testimony and in its S-4 filings at the SEC. As stated by Barbara Alexander:

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 its services.

Alexander Surrebuttal at 2. Just one significant failure in just one of these categories can have a strong negative impact on service quality.¹¹² As pointed out in the testimony of Barbara Alexander, FairPoint itself has unfortunately provided a good example of what can go wrong when a new billing system is created:

In light of the historical billing system software failures that FAIRPOINT itself has experienced in Maine, that dramatic set of changes suggests that this Commission should, if this transaction is approved, include specific and enforceable service quality standards so that those risks are transferred from customers and ratepayers to FAIRPOINT and its owners.

Id. Another notable example of serious cutover failure is occurred in Verizon's sale of its Hawaiian exchanges, which took place under circumstances similar to the instant transaction, and where new back-office systems were also created by a third party. *See, Alexander Direct at 14-15.*

Like FairPoint, Capgemini lacks experience with an operational system cutover and integration of this magnitude. *TR Oct. 10 at 139, 239.* In view of the fact that the highly integrated cutover changes are so significant, and because FairPoint understands that those risks

¹¹² FairPoint witnesses Haga and Kurtze confirmed that these widespread software changes are "highly integrated." Rebuttal of Haga/Kurtze at 33.

can result in adverse consequences,¹¹³ it is unfortunate that FairPoint has failed to prepare a formal risk analysis that identifies the specific risks and lists the steps that need to be undertaken to avoid problems. FairPoint witness Haga freely admits to FairPoint's lack of risk-mitigation planning. *TR Oct. 10 at 141*. On re-direct, Mr. Haga testified that FairPoint and Capgemini do plan to mitigate risk by means of extensive testing before cutover. *TR Oct. 10 at 215*. However, until the results of such testing are known, the Commission cannot now conclude that risks are mitigated, or that costly TSA extensions will not be necessary. In order to effectively mitigate such risks for ratepayers, the Commission should adopt the service-quality conditions and performance standards recommended by Ms. Alexander. In that way, the risk of failure, and additional expenses that FairPoint may incur, will be transferred from customers to shareholders. In addition, the Public Advocate has recommended other conditions relating to the risk that FairPoint may incur additional TSA expenses.¹¹⁴

One of the most formidable risks arises as a result of the highly complex and integrated nature of the new operational systems. Mr. Haga does not deny that integrated nature of the new systems presents certain unique risks. *TR Oct. 10 at 150*. Mr. Haga's explanation of the term "integration" is instructive in understanding that numerous inter-dependent functions will be at risk. *See TR Oct. 10 at 149*.¹¹⁵ In light of the complexity and risks associated with FairPoint's

¹¹³ See S-4 disclosures, *Alexander Direct at 12*.

¹¹⁴ See proposed conditions 6 and 7.

¹¹⁵ MR. BLACK: Can you explain what you mean by the description highly integrated?

MR. HAGA: The software applications themselves, take for instance our order entry system and our new systems that we are putting together. The order entry system could take all the information about an order, about a customer, what services they want, what date they want the services, pricing in which was negotiated, and so forth, that -- that's resident in this system. Now the actual application that will accumulate all the call records, generate all the charges, calculate taxes and so forth -- the billing system -- that -- that can stand all by itself. The highly integration is these systems -- the software that we're actually -- Capgemini's developing for us allows those systems to talk to each other, having a normal conversation. Verizon systems which on record indicated 600 systems, those 600 systems they've done the same thing over time to allow each of the systems, instead of having somebody pick information up out of one system, go to the next system and key that same information in, it

new billing and customer care systems, Mr. Haga refused to provide any guarantee that bills will be accurate after cutover.¹¹⁶ It is true that a complex operational transition can have inherent risks, as FairPoint readily acknowledges. *TR Oct. 10 at 240.*¹¹⁷ However, Maine's basic exchange service ratepayers, who did not ask for this transaction, are the people who will be most at risk, unless the Commission adopts conditions that are effective in transferring the risks either to FairPoint's or Verizon's management and shareholders. One of the risks that might ultimately harm ratepayers is the extremely high costs of the TSA, *TR Oct. 10 at 245*¹¹⁸. In order to reduce the risk that ratepayers will otherwise bear, the Commission should impose a condition that would limit the impact of the TSA costs. That is, as a condition to any approval of Verizon's abandonment of service in Maine, the Commission should allocate substantial amounts of additional responsibility for service failures, or transition failures, to Verizon

Conditions requiring close monitoring and new requirements to be imposed upon FairPoint will be necessary to minimize those risks. In this proceeding, a great deal of attention has been paid to FairPoint's application to become the dominant telephone utility in Maine.

integrate them electronically by allowing messages to go back and forth through systems, batch files to go back and forth through the systems, so the systems can work without human intervention.

¹¹⁶ *TR Oct. 10 at 152.*

¹¹⁷ MR. RUBIN: Okay and you also went through a transition -- a reorganization process for your customer service centers, didn't you?

MR. NIXON: We did.

MR. RUBIN: And that process also had some bumps in the road, would that be fair to say?

MR. NIXON: It had -- certainly had its challenges as most of those -- most conversions do.

MR. RUBIN: Okay. There were a couple of months when customer calls were not handled with the speed and quality that you normally expect. Is that -- is that right?

MR. NIXON: That's correct and we took the steps necessary to rectify it.

MR. RUBIN: Right and you eventually worked it out.

MR. NIXON: Yes sir.

MR. RUBIN: Okay. So there again, the conversion to the new call center set up took a while to come up to the standards you expect.

¹¹⁸ But that costs a lot of money if you have to continue the TSA for two or three months, right?

MR. NIXON: It would.

However, relatively little attention has been given to Verizon's application to abandon service. The risk that service-quality might deteriorate during cutover should be a risk that Verizon is required to assume as a condition for any Commission approval of Verizon's request to abandon service. In order to achieve that transfer of risk, after a reasonable period of time after cutover, Verizon should be required to reduce substantially the charges under the TSA. Furthermore, Verizon should continue to be responsible for the operation of all important systems until their successful cutover to FairPoint's control.

C. The Commission Should Convert FairPoint's Vague Promises About Service Quality Into Enforceable Obligations As Conditions on Any Approval of The Transaction

FairPoint claims that the transaction will result in approximately \$60 million to \$75 million of synergy savings. However, even when faced with clear evidence of Verizon's poor and declining service quality performance, FairPoint has refused to allocate any particular amount of such savings to improve service quality. *TR Oct. 3 at 52*. The Public Advocate appreciates that FairPoint has been willing to add twenty new service technicians specifically to address the problematic "residential troubles not cleared within 24 hours" metric. *See: Brown, Harrington, Smee Rebuttal at 11-12*. In response, Public Advocate witness Alexander withdrew her initial recommendation that the Commission increase the penalties for that metric, provided that FairPoint file a proposal for a graduated penalty that would apply to new set of interim benchmarks. Such a filing would give FairPoint an opportunity to prove that it will address that serious service-quality issue effectively during a two-year compliance period. *Alexander Surrebuttal at 4*. The Public Advocate recommends that all other current service-quality metrics

remain in place, and that the Commission adopt the additional billing error metric, as recommended by Ms. Alexander.¹¹⁹

D. Conclusion – Service Quality

In the absence of particular commitments from FairPoint, the Commission should impose enforceable service-quality conditions on FairPoint, in lieu of its often-repeated, yet vague, promises to address service-quality issues. In the alternative, when it weighs the potential benefits and potential adverse impacts of the transaction, the Commission should assume that FairPoint's general promises have no value. In particular, the Commission should take note of FairPoint's general refusal to make the specific commitments necessary to address known service quality problems proactively.

Even though pressed, FairPoint has failed to acknowledge the need for additional conditions, tougher standards, specific remedial plans, and a specific budget for remediation of service-quality problems. Unless mitigated, the various risks described above threaten to result in service-quality performance by FairPoint that will be worse than that of Verizon. Such an eventuality would constitute a major adverse impact -- the very sort of impact that the Commission must protect against. *35-A MRSA § 708(2) (A) (2)*. Because it cannot predict the future, the Commission should find that the very fact that such substantial risks to service-quality will exist, unmitigated, is itself an impact of the proposed transaction that is adverse to the interests of ratepayers. Unless those risks are eliminated, mitigated, or transferred to the party better able to bear them, the Commission should not approve the transaction. Or, the Commission should proactively impose specific conditions that will transfer the risk of service-quality deterioration from customers to shareholders.

¹¹⁹ The Public Advocate also recommends that all other service quality program determinations to be made in the final Order in Docket No. 2005-155 shall apply to FairPoint, if the Joint Petition is approved.

VI. DSL DEPLOYMENT

A. If The Commission Approves The Sale to FairPoint, The Commission Can Partially Offset Certain Adverse Impacts by Requiring That FairPoint Adopt an Expanded DSL Deployment Program

Dr. Robert Loube proposed an enhanced DSL program that the Commission should be impose as a condition for any approval of this transaction. Dr. Loube's proposal would achieve a rate of 90% DSL addressability¹²⁰ rate and therefore, be more consistent with the broadband deployment goals announced by Maine's Governor. After extensive effort, Dr. Loube collected accurate and consistent data that enabled him to recommend a DSL deployment plan that would be more effective than FairPoint's proposal, while remaining reasonable in cost.¹²¹

FairPoint's proposal falls short in two respects. First, because it proposes to deploy DSL in locations where it would be most profitable, FairPoint's plan does not do enough to bring broadband service to places where it is most needed -- i.e., in places where there is currently no reasonable broadband service at all. Much of the deployment that FairPoint proposes would increase DSL availability in the same areas where Time Warner already provides cable broadband service -- i.e., largely in urban and suburban areas.¹²² While that may be a sound business strategy in an unregulated broadband market, it is a very poor way to implement the state policy that encourages carriers to move toward universal broadband coverage in Maine's

¹²⁰ An addressable line is a line that terminates at electronic equipment that supports DSL service. A qualified line is a line that not only terminates at electronic equipment that supports DSL service, but is also provided over copper loop facilities that support DSL service.

¹²¹ Dr. Loube noted in his direct testimony, at pages 7 to 15, that information used by FairPoint to construct the FairPoint build-out plan was not consistent with Verizon data, and hence, the earlier FairPoint plans could not be accepted due to those inaccuracies.

¹²² Surrebuttal Exhibits RL- 8 and RL-9 show that a significant number of rural wire centers are not scheduled for any additional DSL investment, while urban wire centers -- even those that are currently almost 100% DSL addressable -- are receiving increased levels of investments.

rural areas. *See: 35-A MRSA § 7101(4)*. Dr. Loube attached certain confidential exhibits to his surrebuttal testimony that show that, under FairPoint’s proposal, a substantial number of rural areas would not have DSL service after FairPoint’s build-out plan is completed. *See Ex. RL-8 and RL-9, attached to Loube Surrebuttal*. When asked about those exhibits, FairPoint’s witness Michael Brown did not refute the suggestion that FairPoint’s DSL plan had failed to upgrade service in many rural areas (UNE Zone 3), as noted on Dr. Loube’s exhibits. *See: TR Oct.2 at 24*. Mr. Brown also agreed that FairPoint’s broadband competitors would be more likely to be providing service in UNE Zones 1 and 2, rather than in UNE Zone 3. *Id.* In many instances a competitive market will have good results. However, in this instance, the Commission has been encouraged by the Legislature to adopt policies that extend the availability of broadband services. *35-A MRSA §7101(1) & (2)*. Therefore, if it approves the proposed transaction, the Commission should impose a condition that requires that FairPoint make investments designed to deploy broadband services to the areas of Maine that are unserved. FairPoint should not be permitted to direct its resources so that DSL is deployed primarily to areas that already have broadband service.

FairPoint’s DSL plan is not as cost effective as the plan proposed by Dr. Loube. Although FairPoint’s plan would increase DSL availability beyond that achieved by Verizon, FairPoint’s plan will not move DSL availability sufficiently close to the goal –announced by the Governor – of availability to 90% of customers. On the other hand, the plan recommended by the Public Advocate would substantially improve upon FairPoint’s plan -- throughout Maine, and especially in rural areas.¹²³

¹²³ See Surrebuttal Exhibits RL-1 and RL-2

The Public Advocate agrees with the characterization of FairPoint's DSL plan by PUC Chairman Adams during hearings: FairPoint's DSL proposal is "anemic."¹²⁴ There may be some unavoidable weaknesses in FairPoint's broadband deployment plan due to its inability currently to offer the "triple play." However, FairPoint's plan also has certain self-imposed weaknesses, in that the plan limits DSL deployment, instead of achieving broader deployment at a reasonable cost. In his direct and surrebuttal testimony, Dr. Loube identifies the defects and discrepancies in FairPoint's latest plan, shows that a wider deployment can be achieved in a more cost-effective manner, and demonstrates that it is feasible to achieve the goal of 90% deployment.

Rather than accepting Dr. Loube's deployment proposal, FairPoint has taken every opportunity to cite its statistics regarding the 92% DSL availability in its "classic" territories. However, as the Commission is aware, in its "classic" territory FairPoint is under very different incentives to deploy DSL than it would be in Verizon's non-rural NNE territories. As Dr. Loube testified:

The classic carriers operate as rate-of-return carriers. Those carriers receive on average \$12.27 per line per month in federal universal service funds and this support is not restricted to narrow band service as it is in Verizon's case. On the other hand, Verizon is a "price cap" carrier that receives only \$0.67 per line per month in federal universal service funding (and that support is returned immediately to customers as a bill credit). Because the Classic carriers face a different set of incentives and receive a different level of support than Verizon, it is not possible to use the Classic carriers' experience as an indicator of FairPoint's future actions if FairPoint is ultimately allowed to purchase the Verizon-Maine service territory.

Loube Surrebuttal at 4. It is widely accepted that the federal high-cost fund has served as a *de facto* support mechanism for broadband deployment in the territories of rural independent

¹²⁴ On two occasions, embedded within the Chairman's questions of Mr. Leach, was a characterization of FairPoint's plan as "anemic". *TR Oct. 3 at 141-142.*

telephone companies. If FairPoint replaces Verizon-Maine, FairPoint will face the same economic incentives for broadband deployment that Verizon currently faces in that non-rural territory.

At hearing FairPoint testified that the regulated FairPoint entity will generate a healthy cash flow that would not be significantly impacted by a \$32.4 million rate reduction. *See, e.g. TR Oct. 3 at 133-134.* FairPoint also represented that its projected synergy savings of \$60 - \$75 million will enable FairPoint to reach comfortably a level of 90% DSL availability, based on its forecasted cash flow, and based on the cost analysis presented by Dr. Loubé.¹²⁵ This potential positive cash flow, if made possible by the conditions proposed by the Public Advocate, should be directed to projects that have public-policy significance, rather than permitting FairPoint simply to continue its policy of paying high dividends to its shareholders. However, as noted below, FairPoint claims that it will have a cash-flow cushion that will be sufficient to do both.

The record in this proceeding presents conflicting evidence with respect to the costs of a broadband deployment plan that would be sufficient to achieve a level of 90% DSL addressability. The key difference between Dr. Loubé's cost projection and that of FairPoint is in the estimate of the costs required to attach fiber optic cable to existing poles. The Commission should rely on Dr. Loubé's numbers because those numbers are consistent with the numbers used in the FCC's cost models.¹²⁶ *See Loubé Surrebuttal Ex. RL-3 and RL-4* (cost of 90% addressable DSL program). On the other hand, FairPoint's cost projections were inaccurate and exaggerated, partly because FairPoint used incorrect assumptions -- such as assuming the

¹²⁵ Public Advocate witness Brevitz provides substantial evidence that there is reason to be skeptical that these cash flow projections will materialize unless the Commission adopts certain conditions proposed by the Public Advocate.

¹²⁶ FCC cost model. Fiber cable costs are contained in the *hcpm_inputs_June 2001.xls* file, tab fiber cable, <http://www.fcc.gov/wcb/tapd/hcpm/welcome.html>

need to bore through granite, when, in fact, that would not be necessary, as poles already exist on nearly all of the applicable cable routes.

B. The Commission Should Not Rely On FairPoint's Ability to Effectively Compete With Time Warner Based Upon Its Future Provision of Video Service

The Commission should not rely upon FairPoint's plans for future video service. First, the relatively anemic broadband infrastructure currently planned will be incapable of providing video in many areas of the State. Even where FairPoint plans to provide DSL service, its ability to reach customers with 26-gauge copper loops, which it has no plans to upgrade, will exclude many potential video customers within the DSL-addressable radius.

Second, FairPoint's plans to invest in video service are only speculative. When asked whether FairPoint is proposing to offer a video service using its wire line network in the near future, Mr. Brown responded: "That question will have to be deferred to Mr. Nixon because I don't know."¹²⁷ *Id. at 28.* Mr. Brown further testified that video service will be limited to approximately 10,000 feet, although FairPoint has no plans to move remote cabinets closer to its customers, and although the company has no current plans to replace its 26-gauge copper with the thicker gauge copper that would extend the reach of video service.¹²⁸ *Id., at 29-30.* When questions about prospective video service were asked of Mr. Leach, he estimated that a video product might be rolled out in a period of 9 to 15 months after closing. But he acknowledged that FairPoint would need to obtain municipal franchise agreements in each town, arrange for content, and buy head-end and other associated equipment. *TR Oct. 3, at 198-199.* When Mr.

¹²⁷ When asked about video service, Mr. Nixon said that he did not know what the costs or effort would be required to offer video service. *TR Oct. 4 at 107.*

¹²⁸ Although Mr. Brown did testify that the new MPEG-4 standard could allow for shorter video loop lengths, he offered no specific information about what the required loop lengths would be.

Nixon was asked simply for a “ball-park” estimate of either the cost of head-end equipment or the cost of video content, he said he could not provide such an estimate. *TR Oct. 4 at 107.*

For those reasons, it is not likely that FairPoint will provide a robust video service. If FairPoint’s DSL plan can be characterized as anemic, the video plan is much more so, because it will ride on the same network, but will be capable only of reaching loop lengths that are roughly half as long as the longest functioning DSL loops. Moreover, Verizon’s new \$12 million Verizon DSL investment, which uses DSLAMs and an ATM network, will not be compatible with FairPoint’s planned video technology.¹²⁹ Hence, if video service is deemed to be a crucial component for FairPoint’s long-term success, FairPoint has not met its burden of demonstrating that it is likely to succeed. When considering the merits of the Joint Petition, the Commission should not treat video service as a significant benefit that FairPoint can provide. For these reasons, FairPoint currently lacks the means to compete effectively with cable television providers. As noted earlier, that is also a factor that FairPoint’s financial projections fail to account for.

C. When Seeking to Offset Adverse Impacts to Customers of Regulated Services With Benefits From Unregulated Services, the Commission Should Exercise Special Caution

Because it is under no obligation to grant any §708 approval, the Commission has broad authority under that section to “impose such terms, conditions or requirements as, in its judgment, are necessary to protect the interests of ratepayers.” *35-A MRSA 708(2)*. Hence, as it considers the proposed transaction, the Commission should not hesitate to apply special requirements to any condition that involves unregulated services. For example, if the

¹²⁹ Under cross-examination, FairPoint witness Brown was asked if he would spend the \$12 million expansion budget in the same way, his answer was “no”. *TR Oct. 2 at 96.*

Commission finds benefits in increased DSL investment, the Commission should impose conditions that will ensure that those benefits are not delivered either at the expense of core voice-service customers, or to the detriment of competitors in the unregulated market. The Commission should also impose conditions in such a way that ensures that any benefits associated with State's broadband policies will actually materialize. Unlike the situation where the Commission imposes material conditions on regulated services – i.e., conditions involving service quality or pricing -- the Commission may impose conditions regarding unregulated services only to the extent that the enforcement mechanisms for such conditions are part of the conditions themselves, and are so stated at the time of the decision. In other words, in order to ensure that the anticipated public benefits actually materialize, the Commission must make sure that the conditions contain enforceable benchmarks and penalties.

For example, because the Commission has no jurisdiction to affect DSL pricing, FairPoint may chose to price its DSL service at more than double the rate of Verizon's comparable DSL service. In fact, there is reason to believe that such increases will actually occur. *See TR Oct. 4 at 102-103* (where FairPoint admits that it is making no commitment to continue Verizon's DSL price of \$15 for 768 Kbs).¹³⁰ Accepting FairPoint at its word, the Commission should assume that FairPoint would increase its DSL rates to levels substantially above the DSL rates charged by Verizon. Therefore, the Commission should discount the public benefit to be attributed to FairPoint's DSL proposals accordingly. Among other things, that FairPoint's pricing policy would have a direct, adverse impact on *existing* Verizon DSL customers who will be subject to price increases directly as a result of this transaction. Indeed, that impact would be in violation of the public policy enunciated in Section 7101(4) in which the

¹³⁰ Under certain conditions, Verizon offers this price "for life", not as a temporary introductory rate. *See TR Oct. 4 at 103-104*

Legislature declared and found that “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.”¹³¹ Because there is such limited competition in the market for DSL services, the effect of FairPoint’s pricing policy would be to foreclose the opportunity for lower DSL prices for future DSL customers. For that reason, unless FairPoint will agree to limit the size of any increase in its DSL rates, the Commission should discount the public benefits that might be generated by the expanded availability of FairPoint’s unregulated DSL service.

As the Commission knows, there is no law or rule that precludes FairPoint from adopting discriminatory pricing for DSL service. In other words, rural DSL customers -- the very customers that the Commission is seeking to benefit -- might be required to pay higher DSL prices because it is likely that there will be less competition in the rural broadband market. Similarly, the Commission will have no control of FairPoint’s DSL service quality. If FairPoint fails to deliver good service, the anticipated benefits of extending DSL service will not accrue to rural customers, and the intended beneficiaries of this transaction will be paying higher prices, with no place to submit a complaint.

For the reasons stated above, any benefits anticipated from the expansion of unregulated DSL service should be heavily discounted. Those benefits should be offset by the risks that the proposed transaction might pose to service quality and rates. Customers of local exchange service are entitled to the Commission’s protection with respect to rates and service quality. The Commission’s obligation to regulate voice service in the best interests of ratepayers and to avoid any adverse impacts on those services should not be bartered away for the uncertain and limited benefits that might come with the expansion of unregulated DSL service.

¹³¹ 35-A MRSA Section 7101(4) (emphasis added)

In short, there are a number of reasons that the Commission might find that FairPoint's DSL plan is not consistent with the interests of ratepayers. The DSL plan fails to adequately address unserved rural areas, it fails to bring DSL to a sufficient number of additional lines, its rates will likely be much higher than those of Verizon, there is a substantial risk that the costs of the plan will be subsidized by regulated voice services, and the Commission will have little control over the ongoing benefits from this unregulated interstate service. Nevertheless, if the Commission imposes a condition that requires (a) that FairPoint expand its DSL deployment to the 90% level, as recommended by Dr. Loubé, and (b) that FairPoint provide greater deployment in unserved rural areas, it would be appropriate to view that plan as an acceptable offset to a moderate degree of risk in other areas.

D. The Commission Should Ensure That Any Condition that Requires Further DSL Investment Does Not Permit FairPoint's Unregulated Services to Increase The Risks to Customers of Regulated Services

FairPoint should be required to "ring-fence" the regulated telephone company -- perhaps by creating a separate unregulated subsidiary -- in order to ensure that the regulated entity does not subsidize unregulated or interstate services. One means of accomplishing that would be to apply the substantive requirements of Chapter 820 of the Commission's rules, as a condition for the Commission's approval of the proposed transaction.¹³² In other words, the Commission should ensure that FairPoint's unregulated services pay to the regulated entity the appropriate cost of the loop and of other shared facilities or services related to the provision of unregulated DSL service.

¹³² Chapter 820 establishes requirements that are designed to avoid cross-subsidies between regulated and unregulated affiliates. Currently, it governs Maine's electric and gas utilities but -- for reasons that are not clear -- it exempts telephone utilities. Here, the Commission should impose a condition that requires that, FairPoint be subject to the Chapter 820 rules as a means of isolating the regulated entity from risks inherent in FairPoint's unregulated businesses.

Of particular note is the fact that FairPoint’s financial model assumes a monthly payment from the unregulated entity to the regulated telephone company of **[BEGIN SUPER CONFIDENTIAL]** 11 **[END SUPER CONFIDENTIAL]** per DSL line per month.¹³³ *See, Ex RL-10 of Loube Surrebuttal, Response to ODR-16.* While examining super confidential exhibit RL-10 attached to the surrebuttal testimony of Dr. Loube, Mr. Leach agreed that, when viewed as a stand-alone business, the DSL business **BEGIN SUPER CONFIDENTIAL:** **[REDACTED]**

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] **[END SUPER CONFIDENTIAL]**. *TR Oct. 3 at 45-46.*

For these reasons, the Commission should expressly condition approval of this transaction on FairPoint’s adherence to the assumptions made in its financial modeling, including this cost allocation.

The Commission should also expressly require (a) that FairPoint should provide DSL service through a separate subsidiary (as it currently plans to), and (b) that the separate

¹³³ FairPoint Financial Model, “Detail” worksheet, cells I272:P272.

subsidiary must compensate the regulated entity at market value, or fully allocated cost, for any services there from. The Commission should also monitor the allocation of labor costs by reviewing and approving a cost allocation manual (CAM). FairPoint testified that it has not yet developed such a CAM, that it has not yet drafted the “commercial” agreement between its own prospective affiliates, and that it does not yet know whether its level of costs will be different from those used by Verizon. *TR Oct 10 at 235*. For those reasons, the Commission should also impose a condition that would, at a minimum, reserve jurisdiction to review and approve the cost allocations between the unregulated affiliate and the regulated telephone company.

In the alternative, the Commission should require that FairPoint allocate a portion of the loop and other expenses associated with the provision of DSL service to the non-regulated sector, thereby reducing its state jurisdictional costs. The FCC has found that DSL service is an information service.¹³⁴ While the FCC allows ILECs to continue to treat DSL as an interstate service for the purposes of accounting reports, a state commission is not bound by that accounting decision.¹³⁵ Instead, a state commission could require that the carrier remove DSL costs from its state jurisdictional books and records and place those costs in non-regulated portion of the company.

Unregulated businesses are inherently more risky than regulated utilities. Hence, the Commission should avoid any DSL-related condition that would transfer risks to the regulated utility. Evidence in the record suggests that FairPoint’s DSL business may not be profitable when taking into account the appropriate contribution to the joint and common costs payable to

¹³⁴ United States Court of Appeals for the Third Circuit recently found in *Time Warner Telecom, Inc., v. Federal Communications Commission*, that the FCC could hold that DSL is not a telecommunications service.

¹³⁵ In the Matter of the Appropriate Framework for Broadband Access to the Internet over Wireline Facilities, CC Docket No. 02-33, *Report and Order and Notice of Proposed Rulemaking*, FCC 05-150, released September 23, 2005, ¶ 29, and ¶¶ 128-144.

the regulated entity. The negative profit rate is associated with the payment of a “DSL Line Charge” by the ISP to the telephone company. However, because the “DSL line charge” reported in the model is consistent with the federal tariff; it is presumed that the revenue associated with the line charge is reported as interstate revenue. At the same time, Verizon’s Separations practices assign 75 percent of the line cost to the intrastate jurisdiction. During the AFOR proceeding, the OPA proposed that the Commission act to correct that mismatch between revenues and costs. With the growth in DSL services, it becomes even more important for the Commission to address this issue and to determine a way to “ring-fence” the state jurisdictional regulated telephone company if and when FairPoint requests an increase in its basic service rates. To the extent that FairPoint’s financial projections show that DSL service is not profitable, we are concerned that the company’s business plan relies on a subsidy from regulated ratepayers. Any such subsidy would be adverse to the interests of ratepayers and to the interests of competitors such as GWI. The Commission must take steps to ensure that FairPoint’s regulated rates do not reflect the costs of those unregulated investments and that FairPoint remains in compliance with Section 254K of the Telecommunications Act of 1996.¹³⁶ FairPoint states that it has not yet developed the level of payment to the regulated phone company for the use of the local loop and DSL services. *ODR-26*.

In summary, FairPoint is planning explicitly to expand its unregulated business activities and to give primary focus to those activities. Those plans add to the potential adverse impacts of the proposed transaction by increasing the business risk to the regulated entity. While profits from unregulated businesses will never be booked to the regulated utility, the downside risk is

¹³⁶ Section 254K of the 1996 Telecommunications Act requires state commissions to ensure that services included in the definition universal service (such as basic local service) bear no more than a reasonable share of the joint and common costs of facilities used to provide those services. 47 U.S.C. Section 254k

that, unless the Commission takes steps to insulate the regulated entity, its ratepayers may face higher costs of capital, diminished service quality, and even the business failure of the corporate parent. Several of the Public Advocate's proposed conditions seek to reduce these risks.

E. The Commission Should Adopt a Requirement That FairPoint Offer Stand-alone DSL Service as a Condition of the Transaction

A condition requiring stand-alone DSL service will ensure that the benefits of a FairPoint DSL deployment program would be extended to Maine customers who have chosen, or want to choose, an alternative form of voice communication. The tying of unregulated DSL service to regulated voice service is anti-competitive, and also frustrating for many consumers. In the Verizon-MCI merger case, the FCC saw fit to require stand-alone DSL as one means to offset adverse impacts of that merger.¹³⁷ This Commission then adopted that condition in its own approval of the Verizon-MCI merger. However, the MCI-related condition contained fundamental flaws. For example, it failed to limit the rate charged for stand-alone service. As a result, Verizon charged about \$20 at the outset (presumably to show good faith), but, over a two-year period, Verizon raised the price continually, until the price (for at the *lowest* speed of 768Kbs !) reached the current level of \$47.99 per month for month-to-month service, or \$35.99

¹³⁷ *In the Matter of Verizon Communications Inc. and MCI, Inc.*, FCC 05-184, WC Docket No. 05-75, November 17, 2005.

ADSL Service

1. Within twelve months of the Merger Closing Date, Verizon will deploy and offer stand-alone ADSL within the local service areas of Verizon's incumbent local telephone companies. Standalone ADSL means ADSL service on ADSL-equipped lines without requiring customers to also purchase circuit switched voice grade telephone service. This service will be available both for existing Verizon voice and ADSL customers who wish to port their voice service to a VoIP provider or to another facilities-based provider such as cable or wireless, and for new customers who wish to subscribe only to Verizon's ADSL and not to its voice service. This service will remain available in a given state for two years after the "implementation date" in that state. For purposes of this condition, the "implementation date" for a state shall be the date that Verizon can offer this service on eighty percent of Verizon's ADSL- equipped lines in Verizon's local service area in that state. Within twenty days after meeting the implementation date in a state, Verizon/MCI will file a letter with the Commission certifying to that effect. In any event, this commitment will terminate no later than three years from the Merger Closing Date.

per month for annual service.¹³⁸ Apparently, Verizon does not want to market stand-alone DSL and, unfortunately, was given sufficient authority so that it could price the service out of the market. The Commission should not give FairPoint NNE that same opportunity. The other flaw was that a two-year time duration set by the FCC represented a very limited benefit. The Public Advocate recommends that the Commission adopt, for an indefinite period, the requirement that DSL be offered independently of local telephone service, and at a price commensurate with the unbundled cost of delivering that service. Such a requirement will promote competition, consistent with established State and federal policy.

At hearing, FairPoint refused to commit to a substantial continuation of stand-alone DSL service, even though stand-alone service is widely recognized as a service that is in the public interest. After confirming that Verizon's stand-alone DSL requirement will soon expire, Mr. Nixon testified as follows:

MR. ADAMS: This falls into the bucket of things that you won't say how long you'll do it but you're planning on not discontinuing this or --

MR. NIXON: We've committed that we will take it at least one additional year.

TR Oct. 10 at 236. Unfortunately, FairPoint's commitment to providing only one additional year of stand-alone DSL -- like FairPoint's other one-year commitments (of which there are many) -- is almost meaningless when considered in the context of the larger decision that this Commission must make as to whether FairPoint NNE should be given authority to become Maine's largest telephone company, providing service to 87% of the residential and business customers in the state. Given the dearth of broadband choices in the market in many parts of the State, customers should have access to an unbundled broadband product at a reasonable price for more than

¹³⁸ See, *Docket No.2005-154 MPUC filing by Verizon, effective August, 2007.* The Commission may take administrative notice of these price changes.

simply one year. The Commission should impose a condition that FairPoint provide stand-alone service, at a limited price, for at least five years.

F. The Commission Should Require That FairPoint Offer a Wholesale DSL Service

In his written testimony, FairPoint's witness Michael Skrivan opposed the requirement that FairPoint provide a wholesale DSL service, arguing that FairPoint does not have any advantage over other competitors. *Skrivan Rebuttal at 13*. However, on cross-examination, Mr. Skrivan acknowledged that, in fact, every DSL provider in the state would rely on FairPoint's network in order to deliver any DSL service:

MR. JORTNER: And my question is does not every DSL competitor rely on your network if you're the -- if you're the acquirer of Verizon's assets?

MR. SCRIVAN: I suppose if you limit it to DSL service, it would tend to be a service primarily offered through copper technology which the ILEC promotes. The statement here really does refer to broadband services and there are a number of broadband providers which do not rely on ILEC facilities to provide the broadband services.

MR. JORTNER: But at the same time, there are broadband providers that do rely on the ILEC's facilities, correct?

MR. SCRIVAN: Yes, there are.

MR. JORTNER: And that would include all of the DSL providers in the state, correct?

MR. SCRIVAN: To my knowledge, yes.

TR. Oct 10, at 224. Therefore, contrary to Mr. Skrivan's original assertion, FairPoint has a huge and unavoidable advantage in the DSL market. In order to promote a more competitive market, the Commission should impose a condition requiring that FairPoint provide a wholesale DSL service to competitors, at a price that would allow those competitors to earn a reasonable margin.

Such a condition will allow competitors to offer creative product combinations and will enable consumers to choose among a number of service providers.

VII. RATE IMPACTS -- IF THE COMMISSION APPROVES THE FAIRPOINT TRANSACTION, IT MUST ALSO ADOPT CONDITIONS THAT PROTECT RATEPAYERS FROM THE RISK OF HIGHER LOCAL TELEPHONE RATES.

A. Increases to the Subscriber Line Charge (SLC).

At the time of the hearing, FairPoint witness Michael Skrivan had not finalized his analysis as to likely changes in the subscriber line charge (SLC). However, Mr. Skrivan was fairly certain that the charge would increase as a result of FairPoint's purchase of Verizon NNE. Verizon currently charges a SLC of \$6.39 to all customers. Mr. Skrivan acknowledged that, under FairPoint NNE, a primary line residential customer would likely see a SIC increase of 11 cents, that secondary line customers would likely see a SLC increase of 61 cents, and that business customers would likely see a SLC increase of 11 cents – although multi-line business customers could theoretically see a rate increase of 2.81. *TR Oct. 10 at 26-28. See also, response to ODR-10.* Mr. Skrivan explicitly refused to commit to not raising SLC rates, even though such rate increases would occur for no reason other than the fact that ownership of the NNE properties had been transferred from Verizon to FairPoint.¹³⁹ *Id. at 26.* As acknowledged by Mr. Skrivan, the SLC is part of the Company's rates, and FairPoint has full discretion with respect to any change of that rate.

B. Loss of Contributions from Directory Revenues

Having nearly completed the first comprehensive revenue investigation for Verizon in the last 13 years in Docket No. 2005-155, the Commission is well aware that its Staff has

¹³⁹ The underlying reason for these nearly certain rate increases is that FairPoint will compute its CMT carrier revenue based on the three northern New England states, while Verizon's rate was based on a seven state area. *Id.*

recommended the imputation to Verizon of approximately \$18 million in directory affiliate revenues. That imputation of Yellow-Pages revenue is an imputation the Commission has consistently ordered over the years as part of the policy in support of universal service. The reasons underlying that policy are sound today and will continue to be sound in any future rate case, even if this transaction is approved. However, if the Commission were to alter that policy based on the fact that FairPoint does not have a directory business, then the Commission is faced with a very large adverse impact. That is, ratepayers would be harmed by the loss of \$18 million per year in revenues that now serve to keep local rates affordable. When Mr. Leach was asked whether he would vigorously oppose any imputation of directory revenues in a future FairPoint rate case, he gave a very clear “yes”. *TR Oct. 3, at 21-22.*

The impact of FairPoint’s “no imputation” policy, if successful, would be to increase local telephone rates by \$18 million per year, or approximately by \$3.20 per customer per month. That change in policy would be based on two recent agreements: first, Verizon’s spin-off of the Idearc Media directory company and Verizon’s subsequent non-compete agreement with Idearc; and second, FairPoint’s own agreement not to compete for 30 years with Idearc. *See: ODR-13.* Due to the common ownership of the two subsidiaries, the Verizon-Idearc agreement can hardly be characterized as an “arms length” transaction. In fact, Verizon witness Stephen Smith agreed that, at the time that the non-compete agreement was “negotiated” between the two Verizon business units, there was an “identity of interest” between the parties. *TR Oct. 4 at 283.* Furthermore, that spin-off of Idearc and the associated non-compete agreement was reached – whether serendipitously or consciously -- during the same time period when the NNE spin-off negotiations with FairPoint were reaching fruition. Further testimony from Mr. Smith acknowledged that, if it wanted to acquire Spinco, FairPoint had little choice but to agree to

accept the non-compete agreement between the two Verizon business units, *Id. at 284*. For that reason, it may be appropriate for the Commission to require that Verizon compensate ratepayers for the loss of directory revenues for the next 30 years, unless the Commission is prepared, in future rate cases, to continue its policy of imputing directory revenues to Maine's local exchange carrier – i.e., FairPoint.

Even though competitors exist, the Yellow-Pages business is a profitable business, especially for the incumbent telephone company (ILEC), or its affiliate. The value of that business stems from the fact that the ILEC is pretty much a monopoly provider that, as a result of its monopoly status, has developed an extremely valuable customer list. That list enables the ILEC to distribute advertising to the broad scope of telephone customers. Now, as it proposes to leave the state, Verizon and its Idearc affiliate plan to take that valuable business with them.¹⁴⁰ As a result, in future rate cases FairPoint will have the opportunity, unlike Verizon, to argue that it has no connection to, and derives no benefit from, the lucrative directory business. Whether or not FairPoint was under pressure to agree to the anti-competitive non-compete provision that is part of the proposed transaction, if the Joint Petition is approved, the result -- i.e., the loss of the \$18-million-revenue imputation – will have a significant adverse impact on telephone customers. To reduce that adverse impact, the Commission should impose a condition requiring that, in any future rate case, FairPoint agree in advance to the imputation of an appropriate level of directory revenue. In that way, approval of the Verizon/FairPoint transaction will not have the immediate effect of depriving Maine telephone ratepayers of the \$18-million revenue imputation,

¹⁴⁰ Although Verizon has spun off that business, 100% of the shares went to Verizon shareholders.

C. The Cost of Capital Will be Higher for FairPoint Than Verizon

Earlier sections of this brief discuss FairPoint's high-yield stock dividend, its high debt leverage, and its less-than-investment-grade bond rating (aka, "junk bond" status). FairPoint goes to great length to demonstrate that other telephone utilities are in similar financial circumstances, and argues that even though limits upon certain financial parameters might improve FairPoint's financial condition, those limits are not pertinent issues. However, what certainly is pertinent to the Commission's consideration of the proposed transaction is the difference in financial risk between Verizon and its hopeful successor, FairPoint.

In his written testimony FairPoint witness Michael Balhoff attempts to discount the effect that FairPoint's less-than-investment-grade bond rating will have on its telephone rates. Mr. Balhoff points out that Verizon has made no "written, public commitment to use its higher credit rating to assist any of its telephone operating companies, including Verizon-Maine" *Balhoff Rebuttal at 7*. However, at cross-examination, Mr. Balhoff readily conceded that FairPoint's lower bond rating would result in a higher cost of capital, and -- at the time of a rate proceeding -- would translate ultimately into higher rates. *TR Oct. 4 at 89*. For FairPoint, higher capital costs will also result from FairPoint's generally higher level of risk, its high debt leverage, and its policy of paying out a high level of dividends. The Commission should address that adverse impact -- i.e., FairPoint's higher cost of capital -- by imposing a condition that holds FairPoint's ratepayers harmless from increased capital costs for the next ten years -- the same period of time that the Commission may require a stay-out from any rate proceeding under Chapter 91.

D. FairPoint Already Seeks to Charge Basic Rates That Will Likely be Higher Than Rates That Would Apply to Verizon.

In many areas, FairPoint has made commitments to take, or not to take, certain actions for a period of one year. Because this case will have profound and very long-term implications for the people of Maine, those one-year commitments are virtually meaningless. However, when it comes to its local rates, FairPoint has disclosed a more ominous rate strategy. It seeks immunity from the reductions to local exchange rates that, in the normal course of regulation, will likely apply to Verizon as a result of the Commission's yet-to-be-issued decision in the Verizon-AFOR case (Docket No. 2005-155).¹⁴¹

If, as a result of the proposed transaction, FairPoint's NNE operations in Maine were, for some reason, to be made immune from the rate decrease that Verizon-Maine now appears to be facing, that immunity would constitute an adverse impact inconsistent with the interests of Maine ratepayers. Given the mandate of Section 7101, and Section 7303(2),¹⁴² that adverse impact could not be reduced simply by the adoption of a more broadly distributed DSL deployment program, or by the adoption of improved service-quality standards. In order to address that adverse impact, the Commission should impose a condition on the proposed transaction requiring that FairPoint accept whatever level of local rates that the Commission establishes in its decision in Docket No. 2005-155, the ongoing Verizon-AFOR proceeding

¹⁴¹ [Ironically, at the same time that it argues that it is immune from the rate reduction to be applied to Verizon, FairPoint takes the position that its FairPoint NNE operations will be more efficient than Verizon's NNE operations have been. That is, FairPoint claims that, under its management, it can generate \$60 to \$75 million in "synergy" savings from its operations in Vermont, New Hampshire, and Maine.]

¹⁴² See: Section II above, Standard of Review. Sections 7101 sets out the policy that telecommunications services -- both voice and broadband -- should be available to all customers at affordable rates. Section 7303(2) declares that the Commission shall establish rates for telephone companies which will preserve traditional flat rate local telephone service at as low a cost as possible. Together, those sections identify the interests of ratepayers as 'pocket-book' interests -- i.e., interests in low and affordable telephone rates.

In addition to the specific, and very likely, adverse rate impacts cited above, FairPoint has made it clear that it will generally seek rates that will exceed those that would have applied to Verizon. FairPoint's mantra has been that it only seeks to "step into the shoes of Verizon." However, when faced with the possibility that it might have to accept any revenue reduction that might be ordered for Verizon in the Verizon-AFOR case, FairPoint appears to be asking for a different treatment. That change in position was evident at the time that Mr. Nixon testified, and was most clearly illustrated by the debate between FairPoint's counsel and counsel for the Public Advocate in the form of letters filed with the Commission in this docket.

FairPoint's senior management team appeared to be willing to concede that FairPoint should have no additional rights to alter the rate decision to be made in Docket No. 2005-155 above the rights that Verizon would have. Under the current procedural posture of that case, the only further argument that parties will have are exceptions to the Examiner's Report. At hearing, Mr. Nixon clearly conceded that FairPoint would not pursue an opportunity to open the record, or even argue that rates should be different based upon FairPoint's succession as a different operating utility to which the rates will apply. When questioned by the Hearing Examiner on this point, Mr. Nixon testified as follows:

MS. BRAGDON: And, I -- I want to be clear -- is it your position that you would have the opportunity to file exceptions on the substance of that Examiner's Report -- the four corners of that Examiner's Report -- or is it your position that not only can you file exceptions on the four corners of the Examiner's Report, but in addition, argue that things -- circumstances have changed, and this whole -- in that entire proceeding should no longer be applicable to FairPoint, because FairPoint isn't Verizon?

MR. NIXON: I believe as Mr. Leach -- I think that he stated -- we would want the same rights and opportunities that Verizon would have with regard to the AFOR as distinct from petitioning saying that it didn't apply because of unique circumstances.

TR Oct. 4 at 180. Those statements appeared to prompt FairPoint’s counsel to seek to disavow the testimony of his own client and to present a very different position to the Commission in the form of oral argument and letters. *See TR Oct. 4 at 233-236, and the letter filings dated October 10, and October 16, from Joe Donahue and Wayne Jortner, respectively.*

If the Commission approves the Joint Petition, the Commission should do so only if, at the same time, it imposes a condition that would effectively rule upon this controversy concerning FairPoint’s claim that it is entitled to rates different than the rates would apply to Verizon. Ironically, FairPoint’s current position, if sustained, would inevitably lead to one of the most serious of the potential adverse impacts raised in this proceeding. Ratepayers have sought a fair rate setting process for over seven years. During that period, two remands were handed down by the Maine Supreme Judicial Court, and the Commission remains subject to the most recent remand. If one of the first goals of FairPoint is to preclude a fair rate result in the Verizon-AFOR proceeding after this Commission and the parties expended such an enormous amount of resources to create the record in that case, then that adverse impact, by itself, would be a sufficient for the Commission to reject the Joint Petition.¹⁴³ At the time that it entered into negotiations to purchase Verizon’s NNE properties, and at all relevant times since, FairPoint knew that it was seeking to acquire a utility that was involved in a full revenue requirement investigation and therefore might later be subject to a substantial rate reduction. Therefore, as a condition to approval of the proposed transaction, the Commission should require that FairPoint live up to its promises to “step into the shoes of Verizon.”

¹⁴³ While the ultimate decision on rate policy rests with the Commission, FairPoint has indicated that it may take advantage of all legal rights to challenge the Commission’s policy. That could lead to further litigation at the Maine Supreme Court which, itself, would constitute an adverse impact. Because retroactive ratemaking is generally unlawful, any delay in applying overearnings to rates represents actual and immediate harm to ratepayers, as would the cost of further litigation.

FairPoint’s position is also unjustified and ironic for another reason. FairPoint is predicting between \$60 million and \$75 million in cost savings largely based on the difference in cost between its Capgemini-developed operational systems and Verizon’s corporate allocations for similar functions. Since these systems relate to regulated services, it becomes apparent that, in FairPoint’s view, its costs will be substantially *lower* than those of Verizon. Therefore, all else being equal, if Verizon is currently “overearning,” then FairPoint would be overearning even more. FairPoint should not be permitted to use these cost savings to fund unregulated investments – FairPoint should begin doing business with its rates set at a “fair starting point” and should be permitted to earn no more than a reasonable rate-of-return based on the costs of its *regulated* services.

In addition, evidence in this proceeding reveals two other bases to conclude that FairPoint would be acquiring a utility with rates that are already inflated. **[BEGIN CONFIDENTIAL]:**

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] **[END**

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¹⁴⁴ OPA Ex. 94, Verizon HSR documents, Verizon Communications Strategic Update, November 3, 2005, p.14.

Furthermore, the record contains further evidence that FairPoint has calculated that it has a revenue cushion that would permit it to adsorb a rate reduction. That is, FairPoint represents that it believes it has a sufficient cushion to absorb any rate decrease of the magnitude suggested by the overearnings amount identified by the Commission Advisory Staff in Docket No. 2005-155. During the hearings in this proceeding, Chairman Adams asked Mr. Leach a series of questions concerning the financial impact upon FairPoint of a \$32.4 million rate reduction, the amount of the excess earnings identified by Commission Staff in Docket No. 2005-155. After computing an after-tax effect and anticipated line losses by 2008, Mr. Leach found that the actual effect would be approximately \$16 million. He then testified that FairPoint would have a substantial cushion that could comfortably accommodate that amount of revenue reduction. Mr. Leach also testified that such a revenue reduction would not adversely affect FairPoint's dividend payments, nor would it adversely affect its broadband deployment plan. *TR Oct. 3, at 133-134.* This testimony of Mr. Leach is consistent with the testimony of Mr. Nixon, cited above.

Despite FairPoint's general opposition to the prospect of a revenue reduction, a reduction in local rates might very well benefit FairPoint. Ultimately, it may not be in FairPoint's interests to raise basic rates because an increase might cause some customers to give up their wireline telephone service. Furthermore, it might be in FairPoint's interests to reduce its local rates in the face of increasing competition. When Mr. Skrivan was asked whether he could increase revenues by raising rates, he simply stated, "I do not know the answer to that". *TR Oct 10 at 219.* However, when asked if FairPoint might consider geographic rate de-averaging, he said:

I think we would consider looking at that within the confines of state and Federal rules, within confines of -- of competition and marketing and all of those considerations, so, yes.

Id. at 220. The Public Advocate takes that as an ominous sign with respect to FairPoint's future pricing policies. The Commission should guard against pricing policies that seek to cause those ratepayers subject to the market power of a monopoly provider to pay higher local service rates. While there is some degree of competition from Time Warner, the Verizon ILEC continues to maintain an enormous market share, and therefore it should not be permitted to discriminate among customers based upon the degree of its monopoly power.

FairPoint claims that it is entitled to new rates that are specifically applicable to it. However those statements are simply wrong -- for at least two reasons. First, FairPoint has not produced a scintilla of evidence that would demonstrate that just and reasonable rates for FairPoint would be different than the rates that will apply to Verizon. Indeed, because the Commission has very recently developed a full record in support of its upcoming rate decision, the evidence as to the level of just and reasonable rates for Maine's non-rural telephone utility is fresher and more accurate than it has been at any time in the last decade.¹⁴⁵ Furthermore, although the approved stipulation between Public Advocate and Verizon has temporarily stayed the decision in Docket No. 2005-155, any further delay that stems from FairPoint's legal or regulatory actions will result in calculable, adverse impacts to ratepayers.¹⁴⁶ In addition, if the Commission approves the proposed transaction, any further litigation over starting rates for FairPoint would represent a substantial waste of Commission resources. That waste can be avoided if the Commission simply imposes a condition on approval of the transaction that bars FairPoint from taking any legal or regulatory position that would further delay the rate decision

¹⁴⁵ In fact, several evidentiary items in the record of the instant proceeding, cited above, corroborate the overearning determination made by Commission Staff.

¹⁴⁶ The prohibition against retroactive ratemaking precludes any remedy for a delay in rate decreases. If the Examiner's Recommendation concerning overearning were to be applied directly to rates, as the Public Advocate strongly recommends, then each month of delay would cost ratepayers almost \$3 million.

that would have applied to Verizon in Docket No. 2005-155. Furthermore the Commission should declare that if FairPoint continues to claim that the decision in Docket No. 2005-155 does not apply to it, those arguments would constitute an adverse impact to ratepayers, and therefore would provide sufficient grounds for the Commission to disapprove the proposed transaction.

During the hearing, Chairman Adams expressed similar concerns:

I mean, nobody in this room or in this transaction should assume that the suspension of 2007 and 155 [sic] that we authorized is in any way an indication that the Commission does not intend to revisit that case when it's time and exercise its full regulatory authority. And the transaction, this transaction, from what you have said to me today, I do not expect to be used as a basis and in a future proceeding in order to talk about why revenue reduction is not necessary.

TR Oct. 3 at 13. Mr. Leach did not offer any contrary view at that time. Chairman Adams also appeared to share the Public Advocate's concern that FairPoint's legal and regulatory strategy concerning rates is inconsistent with objectives of the stay of Docket No. 2005-155 and inconsistent with the evidence produced in the record in this proceeding. *See: TR Oct. 4 at 233-234.*

Second, Chapter 91 of Maine's utility statutes authorizes the Commission to order, without any need requirement for the consent of the utility, an alternative form of regulation (AFOR). Under those statutes, the Commission may preclude the utility from asking for new rates for up to ten years. The Commission has the authority to adopt such an AFOR for Verizon before it decides whether to approve the Joint Petition. If the Commission rules on the pending AFOR case first, or if the Commission conditions any approval on FairPoint's acceptance of the final Commission decision in the AFOR case, then FairPoint would have no right to seek different rates for the full period of the AFOR. In order to address FairPoint's overstated rights and inclination to seek higher rates, the Commission should condition any approval on a "stay-

out” of new rate filings for a period of at least five years, with the “fair starting point” in rates determined by the outcome of Docket # 2005-155.

E. The Commission Should Approve the Transaction Only Upon the Condition That FairPoint Investigate Further Opportunities That Might Increase Eligibility For Federal High Cost Support

At cross-examination, Mr. Skrivan was asked a series of questions about the possibility that there might be new federal support opportunities for FairPoint to increase its universal service support. Although the witness generally doubted that such opportunities exist, Mr. Skrivan testified that FairPoint had not done studies to determine conclusively whether such opportunities exist. *See, e.g. TR Oct. 10 at 15, 32.* FairPoint could explore a waiver in order to qualify for rural high-cost loop support, which could be fruitful if FairPoint’s loop investment brings it to over 115% of the national average. However, FairPoint has not done a study to determine if there would be a benefit. *Id. at 30-31. See ODR 9.* In addition, FairPoint could choose to be a rate-of-return carrier instead of a price-cap carrier. However, FairPoint has not done any conclusive study to determine whether a net benefit would be possible. *Id. at 31.* The Public Advocate does not fault FairPoint for not yet having developed answers to all questions about potential enhancement of federal support. Nevertheless, we recommend that the Commission condition any approval of the proposed transaction upon FairPoint’s completion of a conclusive analysis of these issues, and, if applicable, upon an affirmative effort by FairPoint to secure enhanced federal support under any available program.

F. The Commission Should Impose a Condition That Caps Any Increase in Expenses and/or Any Additions to Rate Base that Result From FairPoint's Replacement of Verizon's Operational Systems

FairPoint's witness Michael Skrivan testified that he did not know whether the new back-office systems developed by Capgemini will cost more than the costs for those functions on Verizon's books and accounts. *TR Oct, 10 at 232-233*. Nevertheless, Mr. Skrivan's testimony also states that FairPoint expects that these large investments will be deemed used and useful and will earn FairPoint a return on that investment. Although there is nothing wrong with that conceptually, FairPoint's Capgemini investments were necessitated by the nature of the proposed transaction, rather than being required for the purpose of better serving customers. Therefore, the Commission should adopt a condition that caps the rate-base investment and expenses associated with the Capgemini investments, to the equivalent level applied on Verizon's books and accounts. To its credit, FairPoint does recognize that the Commission can condition any approval upon capping the financial effects of these new investments:

MR. JORTNER: Thanks. You also talked about the transition investments -- the investments on -- such as the Capgemini costs relating to the developing and implementation of new systems that will be used and useful in providing service. Do you anticipate that those will be higher than the associated costs that we've -- that exist under Verizon's (inaudible)?

MR. SCRIVAN: I don't know that.

MR. JORTNER: Do you have any reason to believe the Commission could not cap those costs at the Verizon level if they so deemed appropriate?

MR. SCRIVAN: I would say that -- it's hard to know how to respond to that because the Commission could certainly consider that a condition that they would want to place on -- on the approval of the acquisition.

Id. While it could be argued that these new systems may yield long-term benefits, there remains the offsetting problem that these new systems also present serious risks. Therefore, for the next

five years, ratepayers should be held harmless from any increases in rate base or in expenses that result from new back-office system investments. If, in rate cases that take place more than five years from now, it is determined that those investments prove to have been useful and prudent, then they should be given the appropriate rate-making treatment at that time. Such a condition would preclude any immediate adverse impacts resulting from FairPoint's need to replace Verizon's adequate and fully operational systems for no reason other than this transaction itself.

Finally, FairPoint has admitted that it views the new systems that it is constructing as a "platform" to be used to enable future acquisitions. In no event should the Commission permit FairPoint to use of the "platform" as a method to increase costs allocated to Maine ratepayers. Any extension of the use of the "platform" to provide service to other territories should reduce the pro-rata share of costs to be borne by Maine ratepayers. The Commission should require this benefit to be fully and directly shared with Maine ratepayers as a reduction to cost of service, since it is Maine ratepayers (along with those in Vermont and New Hampshire) that will have paid the cost and borne the risks of the development of the platform.

VIII. THE COMMISSION SHOULD CONDITION VERIZON'S REQUEST TO ABANDON SERVICE UPON CONTINUED COMMISSION JURISDICTION TO INVESTIGATE VERIZON'S PRACTICES, AND APPLY ANY REMEDY, IN CONNECTION WITH THE TEN-PERSON COMPLAINT FILED BY DOUGLAS COWIE AND OTHER COMPLAINANTS

After receiving a 10-person complaint that Verizon-Maine may have violated state and federal law protecting the privacy of its customers, the Commission found that the complaint had enough merit to warrant further investigation. *MPUC Docket No. 2006-274*. The Commission sought to obtain additional information from Verizon and Verizon failed to comply with a direct Commission order to do so. Shortly thereafter, the Commission scheduled a show-cause hearing to determine whether Verizon should be held in contempt. That contempt hearing was then

stayed by a preliminary injunction by the Federal District Court in Bangor, Maine.

Subsequently, the case was consolidated with other similar cases, pursuant to a multi-district litigation order. The case currently awaits action in the 9th Circuit.

The Public Advocate shares the concern of the complainants that Verizon-Maine's customers may be subject to violations of their privacy rights. Those privacy rights have been codified in the statutes that are the direct responsibility of this Commission to enforce, i.e., Title 35-A. Moreover, the Legislature took the extraordinary step of declaring that these telephone privacy rights are of "paramount concern to the State". *35-A M.R.S.A. Section 7101-A(1)*.

The Commission should not allow Verizon to escape potential liability nor should it be allowed to escape investigatory jurisdiction of this Commission, based on any approval of the Joint Petition. The Complainants, and customers in general, have a right to pursue their statutory and constitutional rights. The unrelated fact of Verizon's attempt to abandon service in Maine should not be permitted to serve as an obstacle to this important matter of customer privacy. Ultimately, the federal courts may remand the case to this Commission, or the stay of the Commission's investigation may be lifted. In anticipation of either of those outcomes, it is essential that the Commission impose a condition upon Verizon's abandonment of service that requires that Verizon agree to submit to the Commission's continued jurisdiction over Verizon and its ILEC records. Such a condition will preserve the integrity of the Commission's investigation of the 10-person complaint, and preserve the opportunity for the complainants to seek remedies before the Commission.

IX. IF THE COMMISSION REJECTS THE JOINT PETITION, THERE WOULD BE NO ACUTE RISKS OR ADVERSE CONSEQUENCES TO RATEPAYERS OR INVESTORS.

In this proceeding, the Commission must choose between two companies to be the operator of Maine's large incumbent telephone utility. The majority of the evidence and argument in this proceeding focuses on the attributes of FairPoint and the likely scenarios that would ensue if the Joint Petition were granted. However, the Commission has another choice. Therefore, the Commission should also determine the consequences that would ensue if Verizon continues to serve as Maine's large incumbent telephone utility. The Public Advocate recommends that the Commission find that no serious adverse consequences would result from such a decision. Because Verizon and its predecessors have served Maine for about 100 years, because of its enormous resources, because of its skill and experience, and because this Commission has ample ability to ensure high quality service from Verizon, there will be no adverse consequences if Verizon continues to operate as the major ILEC in Maine. However, some parties have suggested that the very fact that Verizon is attempting to sell its NNE properties somehow compels a different finding concerning the merits of Verizon's continued operation in Maine.

For example, at hearing Chairman Adams asked Mr. Balhoff a series of questions exploring whether there might be possible negative consequences if Verizon were, in essence, "forced" to remain in Maine. *See TR Oct 4 at 53-55.* The Chairman expressed concern about the consequences to Maine's ratepayers of hobbling the corporate strategy of Verizon Communications. The Chairman appeared to have two chief concerns. First, he asked whether Verizon might be weaker financially if it is not permitted to pursue its strategy of withdrawing from Maine, and asked whether that financial weakness might ultimately harm Maine ratepayers.

Second, he asked whether Verizon might simply not have the incentive to make sufficient investments in Maine if the Commission rejects the proposed sale. Predictably, Mr. Balhoff responded that the best policy would be for the Commission to allow investors to do what they want. However, the Public Advocate respectfully suggests that those concerns are unnecessary with respect to this proceeding. Moreover, a review of the promises of continuing investment made by Verizon and its predecessors in advance of earlier mergers suggests that the Commission should not accept Verizon's suggestion that it now should be permitted to focus on its FIOS investments in Massachusetts and Rhode Island instead of serving the people of Maine.

A. Disallowing This Transaction Would Not Significantly Weaken Verizon, Nor Would It Harm FairPoint's Existing Ratepayers.

If the Commission is concerned that interfering with the strategies of Verizon's investors might result in a weakened utility, that concern is misplaced here. Given the ratio of the northern New England business (Spinco) to Verizon Communications as a whole, and given the risks associated with the financial viability of FairPoint Communications, a relatively tiny company with approximately 300,000 access lines nationwide, there is little any regulator in Maine, New Hampshire and Vermont can do to Verizon that would make it nearly as weak or risky as FairPoint. Therefore, to the extent that such a concern has theoretical merit, it would be misplaced in the context of the instant transaction.

In the event that the Commission has any concern about FairPoint's ability to serve its existing Maine customers if the Commission disapproves the proposed transaction, record evidence demonstrates that that is *not* a valid concern. FairPoint stated unequivocally that its viability and ability to serve its Maine customers would not be affected by a rejection of the Joint

Petition. In fact, Mr. Leach agreed fully with the Public Advocate that this should be a “non-issue” in this proceeding. *TR Oct. 3 at 23-24.*

B. Disallowing This Transaction Need Not Result in Continued Insufficient Investment by Verizon.

FairPoint is seeking to create the impression that it will be a boon to Maine’s economic development and network modernization because, unlike Verizon, it will be motivated to make substantial investments in Maine’s infrastructure. However, the uncontroverted fact is that FairPoint plans to invest *less* in Maine than Verizon has in recent years. Both Mr. Nixon and Mr. Leach stated unequivocally that this would be true even after FairPoint’s committed DSL investment. *TR Oct. 4 at 110-111.* However, perhaps more importantly, this Commission has many tools at its disposal to require the investment necessary for excellent service from Verizon. For example, if it appears that Verizon has failed to make sufficient network or operational investments because it would rather pay service-quality penalties than make those investments, then one obvious solution is to raise the benchmarks and increase the penalties until the correct incentives are achieved. The Legislature gave the Commission the power to regulate in that manner and there is no obstacle to the use of those powers. The Legislature has never suggested that the Commission take into account the investment strategies that a telecommunications provider, though regulated in Maine, wants to employ in other states. Although positive incentives may be preferable to negative ones, the Commission can only use the tools that it has. Maine cannot offer dense populations of affluent customers, but it can nonetheless require excellent service from its regulated utilities.

Ironically, one of the key advantages promised by larger telecommunications carriers like Verizon has been the vast resources and skill that a larger entity can provide. Despite its faults,

the Commission can be assured that Verizon presents no risk of insufficient cash flow or insolvency. Moreover, if ordered by the Commission to improve service, the Commission has not had to be concerned as to whether Verizon is capable of compliance.

C. Rejection of This Transaction Would Inevitably Lead To Another

As noted earlier, FairPoint became the preferred candidate for purchasing the Verizon NNE properties because it had the characteristics needed to qualify the proposed transaction for the tax advantage permitted by the Reverse Morris Trust provision of the U.S. tax code. While that tax loophole generated savings for Verizon, millions of dollars that would have otherwise benefited taxpayers were lost at the same time. In short, from the point of view of Maine telephone customers; there is no public-interest advantage to a transaction that involves a Reverse Morris Trust. More importantly, however, there are undoubtedly other possible buyers of the Verizon NNE properties that would offer more advantages and fewer risks to ratepayers, than FairPoint. In short, a Commission decision not to approve this transaction would ultimately be only a relatively minor short-term setback to the corporate strategies of Verizon Communications. Furthermore, such a decision will not have negative effects upon Maine ratepayers.

D. Verizon's Desire To Abandon Service in Maine and Invest Elsewhere Should be Deemed Irrelevant to the Commission's Consideration of the Joint Petition

On cross examination, FairPoint witness Balhoff agreed that promises of substantial benefits had been made to ratepayers when NYNEX was allowed to merge with Bell Atlantic,¹⁴⁷

¹⁴⁷ MR. JORTNER: And, you recall that the Commission approved the merger of Bell Atlantic and GTE with the promise of many benefits? MR. BALHOFF: I remember that there were many promises. *TR Oct 4, at 86*

when Bell Atlantic was allowed to merge with GTE, and when Verizon was allowed to merge with MCI. *TR Oct 4 at 86-88.*¹⁴⁸ The Public Advocate is not aware of any benefits that actually inured to ratepayers as a result of those mergers.¹⁴⁹ However, now that Maine's telephone ratepayers are receiving telephone service from one of the largest telecommunications corporations in the world (i.e., Verizon), and after ratepayers have been promised benefits each time their telephone utility merged into a larger entity, ironically, ratepayers are now faced with the entirely inconsistent concern -- a concern that ratepayers will be worse off if the Verizon and its shareholders are not immediately permitted to abandon service so that Verizon can pursue unregulated investments in other states. The desire of Verizon to proceed to other investment opportunities outside of Maine should not have any bearing on this proceeding because Verizon's effort to focus now on other, out-of-state investments constitutes an abrogation of a consistent regulatory policy that has suggested that customers will receive the benefits, and not the liabilities, of past regulatory decisions that have permitted Maine's largest telephone utility to be owned and governed by a increasingly larger and more distant corporate parent. If Maine customers are served now by a utility whose investors prefer now to invest elsewhere, that is a problem that stems, in part, from past decisions of this Commission. What has happened to the promises by NYNEX, and then by Bell Atlantic, and then by Verizon, to provide telephone service more efficiently, and to invest in Maine's telecommunications infrastructure? Can Maine ratepayers still collect on those promises? Should Verizon be permitted to decide not to provide for its Maine customers the investment in FIOS that it describes each month in the circulars that it encloses with the bills sent to Maine ratepayers?

¹⁴⁸ The Commission may also take administrative notice of its Orders in each one of those merger proceedings.

¹⁴⁹ If those mergers produced synergy savings, the former Commission's refusal to investigate rates during that period foreclosed the possibility of a sharing of those benefits with ratepayers, even while rates were being substantially increased to accommodate access charge reductions.

Regardless of how we got here, even Mr. Balhoff could not bring himself to suggest that the preferences of investors should be an important consideration for the Commission as it makes decisions about the next steps in selecting an entity to provide telecommunications services here in Maine.

MR. JORTNER: Should it -- should it be this Commission's primary concern that Verizon deploys its resources in a manner that's most advantageous for its shareholders?

MR. BALHOFF: I -- I don't know. I'm providing my opinion about the investor perspective.

TR Oct. 4 at 87. The Commission should give little weight to that "investor perspective" – a perspective that even Mr. Balhoff distinguishes from the Commission's priority -- i.e., the public interest. Section 708 does suggest that reorganization can be approved only if it is consistent with the interests of both ratepayers and investors. However, the Commission should consider the large discrepancy between the interests of Maine ratepayers and the interests of people who have chosen to invest in a giant global corporation such as Verizon – a corporation so large that the results of its Maine lines of business barely affect the fortunes of those investors. For those reasons, the preferences of Verizon's investors should carry little weight in the Commission's deliberations. In the past, ratepayers may or may not have benefited from Verizon's size. However, for purposes of this proceeding, Verizon's sheer size can insulate ratepayers from any harm that might theoretically be caused by interfering with investor preferences. That is, even if it were true that Verizon shareholders could gain by abandoning Maine, New Hampshire and Vermont, their failure to seize upon that opportunity will not "hobble" Verizon or make it a weaker utility in Maine. If the Commission rejects FairPoint as Verizon's successor, the

Commission cannot be deemed to have harmed the interests of the ratepayers either of Verizon or of FairPoint.

X. CONCLUSION

For the foregoing reasons, the Public Advocate recommends that the Commission reject the Joint Petition for FairPoint's acquisition of Verizon-Maine and Verizon-Maine's request to abandon its public utility service. However, provided that the Commission were to impose the conditions recommended by the Public Advocate, and provided that the Joint Applicants were to accept a restructuring of the transaction as recommended in the first proposed condition of the Public Advocate, then the Public Advocate would recommend approval of the transaction.

Respectfully submitted,

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