Testimony of
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COMMITTEE ON ENERGY AND COMMERCE
SUBCOMMITTEE ON TELECOMMUNICATIONS AND THE INTERNET
U.S. HOUSE OF REPRESENTATIVES

“THE ROLE OF PRIVATE EQUITY IN THE COMMUNICATIONS MARKETPLACE”

March 11, 2008

Introduction

Aloha and good morning Chairman Markey and members of the Subcommittee. My name is Carlito Caliboso, Chairman of the Public Utilities Commission of the State of Hawaii (the “Commission”). I am privileged to be here today and I thank you for this opportunity to testify.

We were asked to provide testimony on the “Role of Private Equity in the Communications Marketplace” and share our unique perspective and experiences as a State regulator. We wish to be responsive and hope that we can be helpful to this Subcommittee.

We currently regulate a telecommunications public utility known as Hawaiian Telcom, Inc. (“Hawaiian Telcom”), which is ultimately owned or controlled by a private equity firm known as The Carlyle Group (“Carlyle”).

First, it should be recognized that each situation would probably be unique in its own way and the proposed private equity investment would need to be reviewed in detail in the context of its industry, market, and service area. Second, the risks and concerns that may be associated with private equity ownership may not be unique to private equity ownership and may apply to other forms of ownership.

As you know, there may be benefits to private equity investment in the communications marketplace, including the ability to infuse additional investment capital and resources that may not have otherwise been available to be invested in technology and communications infrastructure. Private equity ownership of a communications company may involve certain risks, such as a high-debt structure, and possible effects on employment and levels of customer service.

The risks associated with private equity ownership can be appropriately managed and addressed in existing, well-balanced and flexible State regulatory frameworks that give companies an opportunity to earn a fair rate of return on their investments, while protecting the interests of consumers and the public interest in general.

The Hawaiian Telcom Experience

In 2005, a company controlled by Carlyle sought to acquire Verizon Communications' Hawaii operations known as Verizon Hawaii Inc.[1] Verizon Hawaii Inc. was Hawaii's statewide incumbent local exchange carrier or "ILEC." The proposed transaction would convert the ILEC from a small part of a large regional and international telecommunications carrier to a stand-alone ILEC serving primarily the State of Hawaii, which is now Hawaiian Telcom.

Although the Commission recognized certain benefits of the proposed transaction, it also recognized several risks, and was able to approve the transaction only with the addition of several conditions and requirements intended to address these risks.[2]

Potential benefits of the transaction advocated by the applicants included renewed local focus in the telephone company and the establishment of several back office systems[3] in Hawaii

[1] See Docket No. 04-0140.

[2] See Decision and Order No. 21696, filed on March 16, 2005 ("D&O No. 21696"), at 28-29.

(along with the jobs required to establish these functions), which were previously consolidated and operated out-of-state by Verizon Communications. In addition, more attention would be given to the local market and its needs with the introduction of new products, services and technology. The risks included the proposed high-debt capital structure of the new telephone company, which was proposed to be 82.5% debt and 17.5% equity, and the daunting requirement to re-establish all back office systems in Hawaii, which was necessary because Hawaiian Telcom would be a stand-alone telephone company.

In short, after a detailed review, the Commission found that it needed to impose several conditions to address these and other concerns in an effort to mitigate the risks identified for the protection of consumers and the public interest.[4] I would like to highlight a few of the pertinent conditions the Commission adopted as safeguards:

- Rate Case Moratorium Condition (rate freeze): The buyer committed to not applying for a general utility rate increase that would utilize a test year earlier than 2009.
- Equity Commitment Condition: The buyer was required to immediately infuse additional capital to reduce its debt structure from 82.5% to 76.3% on a consolidated basis with a goal to reduce its debt level to 65% in a shorter period of time.

[3] Examples of such functions performed on the mainland were billing, a network operations center, wholesale ordering, human resources, payroll, accounting, and marketing, among others.

[4] D&O No. 21696 at 29-50.

- Dividend Restriction Condition: Dividends to any equity investor were prohibited without prior Commission approval until it reduced its debt to 65% on a consolidated basis.
- Collaborative Committee with CLECs: A collaborative committee was established that included competitive local exchange carriers or "CLECs" to monitor and resolve transition issues to minimize any adverse effects to competitive carriers.
- Scheduled Service Quality Investigation: A service quality investigation was scheduled for approximately six months after the transition from Verizon to Hawaiian Telcom's back office systems to monitor service quality standards and issues.[5]
- Transfer Restriction Condition for Directory Assets: The buyer was required to obtain Commission approval prior to any sale of its directory assets (or yellow pages), and that any sale would be conditioned on the imputation of revenues in a future rate case.[6]

In addition, any further sale or change in ownership, including any initial public offering, or any other form of transfer, encumbrance, or mortgaging of assets, will require the review and approval of the Commission. The Commission also has broad authority to investigate the public utility and all of its dealings and operations.[7]

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[5] This matter is the subject of an ongoing and open Commission investigation. Docket No. 2006-0400.

[6] Hawaiian Telcom has since requested and received Commission approval to sell its directory assets, conditioned upon, among other things, the use of all sales proceeds to pay down and reduce debt. Docket No. 2007-0123, Decision and Order No. 23825, November 13, 2007.

[7] Chapter 269, Hawaii Revised Statutes, as amended.

These are just examples of some tools that may be available to address certain risks, when there is private equity ownership or any other form of proposed acquisition of a regulated company. We recognize that there may be other techniques that could be used in addressing issues raised in these types of transactions.

Nonetheless, the transition to a stand-alone telephone company has not been smooth for Hawaiian Telcom. In fact, the transition could be described by some as very problematic, to say the least. Although actual telephone service has not been an issue, Hawaiian Telcom experienced many back office systems transitioning problems. These problems primarily involved billing systems and the ordering of services, where the amount of time needed to process customer orders and resolve billing matters increased tremendously. This was very frustrating to Hawaii consumers. At this time, however, I have received no indication that these problems were necessarily due to private equity ownership. The same transition issues could have been present where the transaction involved transforming the company into a stand-alone operation that needed to redevelop all of its back office systems whether the ownership was by private equity, a publicly traded company, or even a cooperative.

Although this story is still being written and the investors' actions will eventually speak for themselves, it does appear that the investors have the capability and do intend to invest needed capital and resources into Hawaiian Telcom. For example, the company has expended additional resources to retain new executive management and senior leadership to guide the company. The company has also informed us that it has invested necessary resources to allow it offer higher speed broadband internet services and is developing offerings for video services to its customers. In addition, the company has stated that despite a recent reduction of approximately 100 management positions, its total count of employees of approximately 1,550 is approximately equal to the number of employees at the time of acquisition.

However, whether the investors continue to follow through with their indicated commitment to continue to invest in Hawaiian Telcom remains to be seen. In the meantime, the regulatory authority and additional conditions I described earlier can be used to oversee the company's operations and actions to protect the interests of the consumers.

Conclusion

Accordingly, the risks of private equity investment in telecommunications companies can be appropriately managed with measured and balanced regulatory approaches, as one would with any other form of ownership. In situations where regulatory authority exists, this can be done without the need for inflexible nationwide approaches, which may not be appropriate or necessary in every situation. Such approaches may result in deterring needed investment in communications technology and infrastructure, which could ultimately be to the detriment of consumers.

I appreciate this opportunity to testify today, and I hope our testimony has been helpful to this Subcommittee. Please let me know if we can be of any further service. I will be happy to try to answer any questions that you may have.

SUMMARY OF MAJOR POINTS

- Each situation would probably be unique in its own way and the proposed private equity investment would need to be reviewed in detail in the context of its industry, market, and service area.
- The risks and concerns that may be associated with private equity ownership may not be unique to private equity ownership and may apply to other forms of ownership.
- The risks associated with private equity ownership can be appropriately managed and addressed in existing, well-balanced and flexible State regulatory frameworks that give companies an opportunity to earn a fair rate of return on their investments, while protecting the interests of consumers and the public interest in general.
- Although the Commission recognized certain benefits of the proposed sale of Verizon Hawaii to Carlyle, it also recognized several risks, and was able to approve the transaction only with the addition of several conditions and requirements intended to address these risks.
- In addition to these conditions, any further sale or change in ownership, including any initial public offering, or any other form of transfer, encumbrance, or mortgaging of assets, will require the review and approval of the Commission.
- The transition to a stand-alone telephone company has not been smooth for Hawaiian Telcom and has been frustrating to Hawaii consumers. At this time, however, I have received no indication that these problems were necessarily due to private equity ownership. The same transition issues could have been present where the transaction involved transforming the company into a stand-alone operation that needed to redevelop all of its back office systems whether the ownership was by private equity, a publicly traded company, or even a cooperative.