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June 4, 2009

VIA ELECTRONIC FILING
James J. McNulty, Secretary
Pennsylvania Public Utility Commission
400 North Street
Commonwealth Keystone Building, 2nd Floor
Harrisburg, PA 17120

RE: Investigation Regarding Intrastate Access Charges and IntraLATA Toll Rates of Rural Carriers, and the Pennsylvania Universal Service Fund
Docket No. I-00040105

Dear Mr. McNulty:

Enclosed please find the Verizon's Reply Brief, being filed by Verizon Pennsylvania Inc., Verizon North Inc. and MCImetro Access Transmission Services, LLC d/b/a Verizon Access Transmission Services in the above-captioned matter.

If you have any questions, please feel free to contact me.

Very truly yours,

Suzan D. Paiva

Suzan D. Paiva

SDP/slb

VIA E-MAIL and UPS DELIVERY

cc: ALJ Susan D. Colwell
Attached Certificate of Service

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of Verizon's Reply Brief, upon the participants listed below in accordance with the requirements of 52 Pa. Code Section 1.54 (related to service by a participant) and 1.55 (related to service upon attorneys).

Dated at Philadelphia, Pennsylvania, this 4th day of June, 2009.

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Investigation Regarding Intrastate Access Charges and IntraLATA Toll Rates of Rural Carriers, and the Pennsylvania Universal Service Fund	: : : :	Docket No. I-00040105

(Limited Re-Opening Per Order Entered April 24, 2008)

VERIZON'S REPLY BRIEF

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Joint Petition of Nextlink Pa., Inc., Docket Nos. P-00991648; P-00991649, 93 Pa. P.U.C. 172 (1999)

In re Federal-State Joint Bd. on Universal Serv., 18 FCC Rcd 22559 ¶ 21 (FCC 2003))

Statutes and Regulations

47 U.S.C. § 254(b)(3)

2 Pa. C.S. § 704

66 Pa. C.S. § 1301

66 Pa. C.S. §3015(a)(3)

66 Pa. C.S. §3015(c)(2)

66 Pa. C.S. §3015(g)

66 Pa. C.S. §3019(h)

52 Pa. Code § 63.161(3)

INTRODUCTION

The main briefs submitted by the rural incumbent local exchange carriers ("RLECs") and the Office of Consumer Advocate ("OCA") merely repeat the arguments from their written testimony without meaningfully attempting to address the abundant contrary record evidence or the testimony submitted by Verizon[1] and the other parties to this investigation pointing out the fatal flaws in their reasoning.

The RLECs and OCA continue to insist that this Commission should use an $18 residential rate "cap" as the departure point for their new state universal service fund ("USF") proposal, even though the record simply does not support maintaining for any purpose this outdated, six-year-old rate level – which itself was the product of a settlement, not based on any evidentiary findings and intended for a completely different purpose when it was adopted in 2003. Given the built-in safeguards of Chapter 30 and the demonstrated effects of competition on the RLECs' retail pricing behavior, there is no need for a residential rate cap to restrict their annual alternative regulation rate increases – and there is certainly no justification for a cap or benchmark as low as $18 for any purpose. If only increased by the rate of inflation, this benchmark would be over $21 today. In fact, the RLECs' and OCA's own testimony regarding "affordability" and "comparability" does not support a residential rate benchmark any lower than $23, and the record in its entirety shows the benchmark could be much higher. But if the Commission establishes a benchmark rate, it should not be tied to allowing the RLECs to establish a new and expanded USF because

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[1] Verizon Pennsylvania Inc. ("Verizon PA"), Verizon North Inc. ("Verizon North") and MCImetro Access Transmission Services LLC d/b/a Verizon Access Transmission Services (collectively "Verizon").

there is no legal or evidentiary basis to require other carriers to finance the RLECs' annual revenue increase opportunities.

The RLECs also fail to confront the consequences to their USF proposal of their failure to present any record evidence to support a cap on their basic business rates. It is undisputed that the business rate caps advocated by the RLECs are $10 or more ***lower*** than the national average single line business rate, and that the RLECs have plenty of room to increase business rates if they wish to do so to exercise their annual revenue increase opportunities. The RLECs do not even attempt to explain why other carriers, including their direct competitors, should be forced through the USF to pay the RLECs to enable them to avoid increasing their very low business rates. While the RLECs' main briefs carefully sidestepped this fatal flaw in their USF proposal, PTA's witness Mr. Laffey recognized it, conceding that "if there was no business benchmark rate," then even if they were constrained in raising their residential rates "the compan[ies] could raise . . . business rate[s] in [their] price change opportunit[ies]" and there would be nothing "for the Fund to compensate." (Tr. at 499-500).

The RLECs and OCA also continue to insist that there is really nothing for the Commission to decide with respect to expanding the USF to fund the RLECs' annual revenue increases under alternative regulation because the RLECs are already automatically entitled to these USF funds. These parties rely on out-of-context language from old Commission orders and alternative regulation plans that pre-date the enactment of the currently effective Chapter 30 statute to contend that the Commission cannot deny them USF funding to cover their annual Chapter 30 revenue increases – an argument that the Commission's own Law Bureau attorneys called "absurd" in briefing to the Commonwealth

Court. (VZ St. 1.1, Exhibit 1 (PUC Commonwealth Court Brief) at 21). The RLECs and OCA fail to explain how their novel USF proposal could possibly be squared with the current version of Chapter 30 of the Public Utility Code – a statute that sets forth a detailed and carefully considered alternative regulation framework explicitly contemplating that any revenue increases permitted under the inflation-based plan formula would be secured through "rate increase[s]," (66 Pa. C.S. §3015(c)(2)), and that contains ***no*** provision to force other carriers to fund the RLECs' annual revenue increases. Nor do they respond to Verizon's detailed testimony demonstrating how their one-sided USF proposal would eviscerate the incentive mechanisms that are the key to alternative regulation and would distort the competitive marketplace, ultimately hurting Pennsylvania consumers and insulating the RLECs from competition and the discipline of the market.

While – to be clear – there is no justification under any set of facts for forcing other carriers to fund the RLECs' annual revenue increase opportunities through the USF, it is significant that the RLECs did not establish that these new USF subsidies are actually needed for them adequately to serve their customers and meet their operating obligations. The record here presents nothing more than claims of absolute entitlement to these subsidies and vague generalities about hypothetically higher costs – while the RLEC and OCA witnesses concede that they deliberately did not examine the finances or profitability of any of the individual RLECs. The Commission can only infer from this failure of proof that the RLECs do not need these USF subsidies to support their operations and are seeking a pure windfall. For this reason alone the Commission should reject their proposal.

In short, the main briefs submitted by the RLECs and OCA do not take on the legitimate criticisms of their self-serving USF proposal. They do not explain why this

Commission can or should allow the RLECs to have it both ways by ensuring them, through the USF, the revenue guarantees of rate-of-return regulation (at the expense of other carriers, including their own competitors), while at the same time allowing them to reap all the benefits of alternative regulation, such as freedom from an examination of their profits and finances, full pricing flexibility for competitive services and annual inflation-based revenue increases without regard to costs or need. The Commission should make clear that if the RLECs wish to exercise their annual revenue increase opportunities then they must operate under alternative regulation as the Legislature intended and either find a way to obtain that revenue through rates charged to their own end users (without being subject to an outdated $18 rate cap) or bank it, but they will not be permitted to force anti-competitive subsidies from other carriers through a new and expanded USF.

ARGUMENT[2]

I. RETAIL RATE CAPS

A. Any Existing Rate Caps Should Be Eliminated Or Raised

The RLECs and OCA have failed to present record evidence sufficient to support an $18 cap on RLEC residential rates or any cap on business rates — and particularly not a "cap" to be used as a demarcation point above which other carriers must divert money to the RLECs to provide the annual revenue increases that the Legislature expected the RLECs to obtain through their own end-user rates under their alternative regulation plans. If the Commission determines to set a rate benchmark for any purpose as a result of this

2 Verizon has followed the briefing outline, but has shortened the headings to facilitate a more readable presentation. Where Verizon did not address an issue, the heading was omitted. Additionally, as the presiding officer recognized was a possibility, certain issues arose in the presentation of the evidence that were not separately addressed in the outline (such as the business rate cap issue) and Verizon has inserted subheadings to address those topics where they fit into the presentation. *See* June 19, 2008 Scheduling Order at 6 ("the outline is not meant to limit the subject matter of evidentiary presentations").

investigation, its decision must be supported by substantial evidence.[3] The evidentiary record here conclusively shows that no residential cap or benchmark is needed at all, but that if one is established for any purpose, then the record cannot support an $18 level and cannot support any business rate cap at all.

1. The Commission Has Authority To Eliminate, Alter Or Limit The Applicability Of Any Rate Benchmark

The RLECs and OCA devote much paper to arguing that the $18 residential rate benchmark is a "rate change limitation" that was "codified" by the enactment of 66 Pa. C.S. § 3015(g) as part of Act 183 at the end of 2004, apparently to suggest that the Commission cannot or should not alter the $18 cap.[4] (PTA Main Br. at 18, 24; *see also* OCA Main Br. at 35). Verizon does not agree that this is a "rate change limitation,"[5] but even if it were, that does not mean the Commission lacks the authority to increase it or to eliminate it based on the record evidence presented here. This Commission has already concluded that "nothing in Act 183 in general, or Section 3015(g) in particular, . . . denies this Commission authority to modify rate caps that existed prior to the passage of Act 183, based on the facts

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3 2 Pa. C.S. § 704.

4 Section 3015(g) states that:

> The annual rate change limitations set forth in a local exchange telecommunications company's effective commission-approved alternative form of regulation plan or any other commission-approved annual rate change limitation shall remain applicable and shall be deemed just and reasonable under section 1301. 66 Pa. C.S. § 3015(g).

5 This legal issue of whether any $18 rate cap that might exist is a "rate change limitation" is before the Commonwealth Court in the D&E appeal and need not be decided by the Commission here. Should the Commission reach this question, it should first hold that the $18 rate cap established "for a minimum three (3) year period January 1, 2004 through December 31, 2006" has already expired by its own terms. (7/15/03 Order at 18). Alternatively, it should find that this rate cap adopted via a settlement for a limited duration and for the specific and limited purpose of controlling the pace of access rate rebalancing is ***not*** broad enough to constitute a "rate change limitation" under Section 3015(g).

of a specific case."[6] As the Commission noted, "[t]he final sentence of Section 3015(g) is a transitional provision, intended to preserve existing Commission-approved rate change limitations upon the effective date of Act 183. We see nothing in that provision that limits the Commission's authority to subsequently modify Commission-approved rate change limitations." (*Id.*) Thus, as the Commission's Law Bureau argued to the Commonwealth Court, "[a]ssuming a rate cap remains in effect, nothing in Section 3015(g) removes the Commission's authority to waive or alter the cap." (VZ St. 1.1 Exhibit 1 (PUC Commonwealth Ct Br.) at 36). The OCA and certain RLECs conceded the Commission's authority to alter any existing rate cap in their reply briefs before the Commonwealth Court.[7] These parties have likewise conceded in their main briefs in this case that the Commission has authority to increase or eliminate any $18 rate cap in the future.[8]

In short, as the Commission has already concluded, nothing in Section 3015(g) prohibits a Commission-approved "rate change limitation" from expiring by its own terms, precludes it from being limited to the situation where a carrier is rebalancing access rates, or prohibits the Commission from revisiting and revising or eliminating the limitation based on an evidentiary record.[9] As discussed below, the record here does not support establishing or

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6 *2006 Annual Price Stability Index / Service Price Index Filing of Buffalo Valley Telephone Company*, No. P-00981428F1000 (Opinion and Order entered April 9, 2008) at 12.

7 OCA Commonwealth Court Reply Brief at Dockets 847 CD 2008 and 940 CD 2008, at 6-7 (pertinent portions appended to Verizon St. 1.2 (Price Surrebuttal) as Exhibit 1)); D&E Commonwealth Court Reply Brief at Dockets 847 CD 2008 and 940 CD 2008, at 22 (pertinent portions appended to Verizon St. 1.2 (Price Surrebuttal) as Exhibit 2).

8 *See* PTA Main Br. at 18 ("rate caps continue until otherwise revised by the Commission"); *id* at 38 ("the benchmark rate should be re-calibrated periodically"); OCA Main Br. at 13 ("rate cap . . . may need to be adjusted from time to time").

9 Both the RLECs and the OCA cite to a floor statement by Representative William F. Adolph that the new Chapter 30 legislation "grandfathers rate change limitations" and that "there is an $18 cap for basic telephone service." (PTA Main Br. at 25; OCA Main Br. at 5, 35). Representative Adolph's statements are not at all inconsistent with this Commission's own interpretation of Section 3015(g) as preserving the Commission's authority to alter or eliminate any $18 rate cap. The Representative made this statement in 2004 (before the December 31, 2006 expiration date of the $18 cap), and he

maintaining an $18 residential rate cap, or any business rate cap, and the Commission should exercise its authority to eliminate any such cap here.

2. The Record Does Not Support An $18 Residential Rate Cap

The Commission must look to the evidentiary record developed in this phase of the investigation to determine whether any residential rate cap is appropriate and if so, the level of such a cap. The evidence does not support any cap, let alone the $18 residential rate cap advocated by the RLECs and OCA.

a. Chapter 30 Already Provides Sufficient Safeguards For Annual Revenue Increases

As Verizon explained in its Main Brief, no rate caps are needed in connection with RLEC alternative regulation revenue increases because the built-in safeguards of Chapter 30 and the competitive market already operate reasonably to constrain rate increases in this context. (VZ Main Br. at 8-11). In fact, Act 183 does not itself impose a cap on RLEC rate increases, and it does not provide for other carriers to subsidize the RLECs' exercise of their annual revenue increases at all, but to the contrary presumes that this new revenue would be secured through "rate increase[s]." 66 Pa. C.S. §3015(c)(2). OCA concedes that it is trying to make up for what it views as a deficiency in Act 183, because that statute limits Verizon from placing the entirety of its revenue increase on residential customers (66 Pa. C.S. 3015(a)(3)) but does not impose any similar limitation on the RLECs' distribution of their opportunity among residential or other rates, theoretically at least allowing them to place the whole increase on residential rates. (OCA Main Br. at 4). But it is not for this Commission

never said that the cap would last forever or that it was "grandfathered" without all of its attendant limitations and conditions, including the Commission's authority to revisit and revise it. But even if Representative Adolph had explicitly stated otherwise, "statements made by legislators during the enactment process are not dispositive of legislative intent." *Washington v. Baxter*, 553 Pa. 434 (Pa. 1998).

to attempt to re-write legislation to impose a cap on RLEC residential rate increases that the Legislature chose not to include. Moreover, while Act 183 may not have explicitly limited the RLECs' allocation of revenue to residential rates, it does presume that the RLECs' decisions will be constrained by the operations of the competitive market and it preserves this Commission's jurisdiction to ensure that end user rates remain just and reasonable under Section 1301. 66 Pa. C.S. § 1301. *See also* 66 Pa. C.S. § 3015(g); 66 Pa. C.S. § 3019(h). For these reasons, the creation of additional safeguards beyond those intended by the statute is unnecessary. Further, as discussed below, the record shows that the RLECs have plenty of room to increase their existing residential rate levels before they even begin to approach the most conservative "affordability" level of $23, so there is no need for a rate cap at this time.

If the Commission nonetheless wishes to establish a residential rate benchmark for some purpose, then it must be set at a higher level than the five-year-old $18 benchmark (for the reasons discussed below), and it should function as a safe harbor rather than an absolute cap. So long as an RLEC's rates remain below the safe harbor level, any increases are automatically deemed just and reasonable without requiring further scrutiny, but if the RLEC proposes to increase residential rates above the safe harbor level, the Commission may conduct a more detailed analysis of whether the resulting rates will be just and reasonable considering the particular facts and circumstances relating to that RLEC and its customers. But the rate cap should not be tied to the RLECs' new USF scheme and ultimately any new revenue the RLEC receives must come from its own end users, not other carriers.

b. The Record Shows That Any Residential Rate Cap Would Have To Be No Lower Than $23

The record evidence simply does not support continuing to use $18 as an RLEC residential rate cap or benchmark for any purpose, and shows that if any rate cap is retained it must be much higher than $18. The RLECs and OCA continue to appeal to the general concept of "affordability" as the primary basis to support an $18 cap on RLEC residential rates. PTA vaguely contends that if service is "unaffordable," customers "will be forced to do without local telephone service." (PTA Main Br. at 9; *see also* OCA Main Br. at 19-20 (extensive discussion of the consequences of the lack of "affordable" telephone service)). But as Verizon pointed out in its Main Brief, the only witness to present evidence of "affordability" for basic residential rates in Pennsylvania was OCA's Mr. Colton, who quickly admitted that, even under his absolute most conservative analysis, the "affordability" level in Pennsylvania is $32 – and as Mr. Price demonstrated it is actually much higher.[10] (*See* VZ Main Br. at 13). As Mr. Colton explained, when fees and taxes are included, the $18 rate cap is equivalent to about a $27 local telephone bill, which is ***a full $5 lower*** than the most conservative "affordability" level of $32. (VZ Main Br. at 14). Mr. Colton made clear that he was not asserting that the concept of "affordability" supports an $18 rate cap, and thus he was not testifying in support of an $18 rate cap or any particular level of rate cap. (Tr. at 138-139).

In another spin of the "affordability" argument, both OCA and the RLECs in their Main Briefs make the vague and unsupported assertion that "[r]esidential rates above the $18 cap would adversely impact telephone penetration rates." (PTA Main Br. at 32; *see*

[10] OCA's Main Brief asserts that Mr. Colton's testimony supports a $31 affordability level, (OCA at 22), but Mr. Colton admitted on cross-examination that this is an outdated figure and that $32 is the most current calculation of the "affordability" level under his most conservative analysis. (Tr. at 132).

also OCA Main Br. at 5, 22). But as Mr. Price explained, nothing in the record shows or even suggests that increasing RLEC basic residential rates over $18 would reduce telephone penetration. FCC statistics show that on a statewide basis the annual average telephone penetration rates for Pennsylvania has increased from 95.6% in 2004 to 97.7% as of March 2008, a period when regulated basic exchange rates have also generally been increasing under Act 183's inflation-based formula. (VZ St. 1.1 (Price Rebuttal) at 28). While OCA contends that "the penetration rate in rural Pennsylvania is lower than the statewide average," (OCA Main Br. at 22), Mr. Price demonstrated that most of the geographic area OCA refers to is served by Verizon and that "this data may reflect customer migration to wireless service or VoIP providers in lieu of traditional wireline telephones." (VZ St. 1.1 at 28). In short, OCA's "telephone penetration data does not support any assumptions about what would happen if certain RLECs increased their residential basic service rates over $18." (*Id.*) Since OCA's "affordability" witness testified that all of the RLECs presently charge rates below the most conservative affordability level, there is no basis to conclude that raising those rates would affect telephone penetration.

If the Commission were to look only to "affordability," then based on the record developed here, it would have no alternative to increasing the $18 rate cap by at least $5 – to $23 – and the record would support increasing the rate cap above $30.[11] Obviously the evidence on "affordability" does not support the RLEC/OCA position to maintain an $18 rate cap, and instead it conclusively refutes their argument. Thus these parties are forced to rely on some other argument to suppress the "affordability" result, which they did by

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[11] The calculation of a $23 rate cap is based on the fact that the $32 most conservative affordability level is a full $5 higher than the $18 rate cap, which is really a $27 cap when adjusted for fees and taxes. Adding $5 to $18 yields $23. Similarly, if the affordability level is really in the range of $43, (VZ Main Br. at 14), then the rate cap could be raised by more than $10, yielding a new cap in the range of $30.

contending that the Commission has some additional independent obligation to keep the RLECs' basic residential rates "comparable" to Verizon's regulated rates, even if doing so would keep them substantially lower than the "affordability" limit. This argument is faulty both as a matter of law and as a matter of fact.

As a matter of law, OCA and the RLECs are wrong in asserting that this Commission has a legal obligation to evaluate the comparability of RLEC basic residential rates to "urban" rates or to Verizon's rates. The only legal basis the RLECs and OCA advance in support of their additional criterion of "comparability" is a provision of federal law set forth at 47 U.S.C. § 254(b)(3), which lists as one of the governing "principles" for the FCC and the Federal-State Joint Board on Universal Service that "[c]onsumers in all regions of the Nation, including low-income consumers and those in rural, insular, and high cost areas, should have access to telecommunications . . . at rates that are reasonably comparable to rates charged for similar services in urban areas." 47 U.S.C. § 254(b)(3). (PTA Main Br. at 32-33; OCA Main Br. at 15).

But this is a mandate to the FCC and the federal Universal Service Board in developing ***federal*** universal service policies, not a mandatory limitation on state commissions' exercise of their own authority over intrastate retail rates. At most the citations provided by the OCA and RLECs stand for the proposition that the states may voluntarily choose to apply a "reasonably comparable" principle – not that the states must do so.[12] In fact, the OCA admits that only some and not all states apply a standard of

[12] For example, the PTA relies on *Tex. Office of Pub. Util. Counsel v. FCC*, 183 F.3d 393 (5th Cir. 1999) (PTA Main Br. at 34, n. 81), but that Court made clear that Section "254(b) identifies seven principles the FCC should consider in developing its policies; it hardly constitutes a series of specific statutory commands," and in fact is nothing more than "aspirational language." 183 F.3d at 421. Similarly, both parties cite to passing statements in an FCC order that "the states should continue to have primary responsibility for ensuring reasonably comparable rural and urban rates," as if the FCC had held that the states *must* apply a comparability standard. (OCA Main Br. at 15; PTA Main Br. at

"reasonable comparability" to urban rates, (OCA Main Br. at 15-16), and that even those that do so have taken widely ranging views of what percentage or margin above urban rates could be considered "reasonably comparable." The RLECs and OCA point to no Pennsylvania authority mandating the application of a "reasonable comparability" standard to the RLECs' basic residential service rates.[13] In fact, the Commission's Law Bureau in the D&E Commonwealth Court appeal argued that "[t]his federal regulation pertains to federal universal service and is not a mandate to state Commissions. It has no bearing on rural ILECs' receipt of monies from the PaUSF, but may be relevant to non-rural ILECs' participation as recipient carriers regarding the federal USF." (VZ St. 1.1, Exhibit 1 (PUC Commonwealth Court Br.) at 38). Therefore, this Commission should not attempt to make any comparison to Verizon's basic residential rates – which as Verizon explained in its Main Brief have themselves been kept artificially low by many years of regulatory limitations and do not provide a valid point of comparison. (*See* VZ Main Br. at 17). Based on the "affordability" evidence alone, any rate cap cannot be lower than $23.

But even if this Commission were to look to the principle of "reasonable comparability" with "urban" rates as described in Section 254(b)(3), as a matter of fact that analysis would not permit the Commission to keep the rate cap as low as $18. Implicitly

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33) (citing *In re Federal-State Joint Bd. on Universal Serv.*, 18 FCC Rcd 22559 ¶ 21 (FCC 2003)). But the primary point being made in that order was that "the states retain jurisdiction over intrastate rates," not that federal law constrains the states' exercise of that sovereign authority. *Id.* In fact, although that order was partially vacated on appeal, the Tenth Circuit upheld as correct the FCC's conclusion that "the Act does not mandate state action" with regard to universal service. *Qwest Communs. Int'l, Inc. v. FCC*, 398 F.3d 1222, 1231 (10th Cir. 2005).

[13] PTA suggests that the Commonwealth Court addressed this issue in the appeal of the *Global Order*. (PTA Main Br. at 34, n. 81). But the Commonwealth Court merely recognized that the Commission had argued on appeal that Section 254(f) generally authorizes state commissions to mandate a universal service fund – and did not address the issue of "comparability" of urban and rural rates. *Bell Atlantic-Pennsylvania v. PUC*, 763 A.2d 440, 497 (Pa. Commw. Ct. 2000). Notably, Act 183 does not impose a standard of "comparability." *See, e.g.*, 66 Pa. C.S. § 3011(2) (stating Legislative policy to "maintain universal telecommunications service at affordable rates.")

recognizing the weakness in its comparability argument, PTA attempts to construe "reasonably comparable" as mandating rates "equivalent" or "equal to" Verizon's rates. (PTA Main Br. at 35). But there is no support for that interpretation. As OCA notes, even those states that look to "reasonable comparability" with urban rates do not insist on strict equality and have set margins as high as 130% and 150% of urban rates as meeting this standard. Neither OCA nor the RLECs assert that these states are violating principles of "comparability" by using these ranges. (OCA Main Br. at 16). PTA itself concedes that some margin above urban rates would be appropriate, but suggests an unreasonably low 115%. OCA advocates a slightly higher 120% margin – itself still completely arbitrary and too low as explained in Verizon's Main Brief. (VZ Main Br. at 17). Given the evidence that the affordability level is much higher than the regulated rates that Verizon is permitted to charge for basic residential service and given that Verizon's rates have been kept artificially low by many years of regulation, if the Commission looks at all to "comparability" it should use the highest margin cited by the OCA, 150%.

But as Verizon explained in its Main Brief, even using PTA's unreasonably low 115% margin, the comparable rate is already more than $18 and would be expected to increase over time as Verizon exercises its own price change opportunities. (VZ Main Br. at 18). The current average basic residential rate in Verizon's urban Density Cells 1 and 2 is $16.21, and 115% of that rate is already more than $18. If one uses OCA's advocated 120% margin, the "comparable" rate is $19.45.[14] If one uses the highest range of comparability cited by the OCA in other states of 150%, the comparable rate would be $24.32, which as

14 OCA asserts that the benchmark "should only be increased when Verizon Pa rates exceed $15.00," (OCA Main Br. at 48), but if one correctly looks to urban rates rather than statewide rates, Verizon's rates already substantially exceed $15 and can be expected to continue to increase.

discussed above, is within the range suggested by OCA's most conservative affordability analysis.

Because the comparability analysis does not support an $18 rate cap, OCA relies on an unsupportable argument to suppress the Verizon rate to which it benchmarks "comparability" by using a statewide average value rather than Verizon's urban rates to achieve a lower ultimate result. Due to historical regulatory constraints on Verizon's pricing, its rural rates are lower than its urban rates. But OCA admits that the "federal law" on which it relies – which is the only source of support cited by any party for a "comparability" analysis – requires rates to be "reasonably comparable to ***urban*** rates for such services," not to statewide rates or rates in other rural areas. (OCA Main Br. at 16) (emphasis added). OCA does not explain how it could possibly rely on this statute and yet still look to statewide rather than urban rates. Even OCA's "Conclusion" to its Main Brief concedes that it is really only arguing that RLEC rates should be "reasonably comparable to those services provided in ***urban*** areas at rates that are reasonably comparable to rates charged for similar services in ***urban*** areas." (OCA at 70) (emphasis added). Therefore, OCA effectively acknowledges that, just like its "affordability" analysis, its "comparability" analysis does not support an $18 residential rate cap.

OCA also attempted to present a "cost study" in support of maintaining $18 rate cap, (OCA Main Br. at 29-34), but OCA's cost study is not pertinent or helpful in answering the ultimate question of whether $18 is an appropriate level at which to cap RLEC rates. OCA attempted to calculate an "incremental cost" for providing basic local service that does not include the cost of the local loop, but only the other network costs associated with providing service – an exercise that itself was flawed by the use of faulty data.[15] OCA then argues that an $18 "cap" on RLEC basic local service rates is reasonable because the "cap" is not below the purported "incremental" non-loop related cost of providing service. But as Mr. Price explained, it is not reasonable to argue that RLEC basic local service rates should be capped at a level that is at or near the "incremental" costs of service without regard to the loop costs – particularly when OCA itself asserts that the cost of the loop is 84% to 91% of a carrier's costs. (VZ St. 1.1 at 37). OCA's witness agrees, conceding in his surrebuttal testimony that he is not asserting that basic residential service should be priced at "incremental cost," that he agrees that the price should be set above his asserted incremental cost to contribute to loop costs, and that the appropriate amount of contribution would be determined based on "the principles of comparability and affordability." (OCA St. 1-S (Loube Surrebuttal) at 8). In short, OCA concedes that its cost evidence is not relevant. The real question presented is what portion of the RLECs' loop costs should be recovered through these residential rates before the rates reach a level that is no longer just or reasonable, and whether it is necessary to impose a cap or benchmark in advance to control them from reaching that level. OCA's cost argument does not address that issue.

Accordingly, the only reasonable alternatives supported by the record here would be to hold that there is no cap on RLEC residential rates (relying on the natural constraints and incentives built into Chapter 30's alternative regulation framework) or to increase the cap to

15 OCA used data derived from the FCC's Synthesis Model, which is a series of algorithms developed by the FCC for the purpose of distributing federal universal service support among the states for non-rural carriers. But as Mr. Price explained, this model was not designed for the purpose for which OCA attempted to use it because it was designed solely to support the federal universal service program and determine relative cost differences among states for the purpose of distributing national high-cost funds. The FCC did not develop, nor intend for, the Synthesis Model to be used to estimate state-specific or company-specific forward-looking costs and has repeatedly stressed that the Synthesis Model should only be used "for the limited purpose of comparing relative cost differences between states," and should not be used as an absolute estimate of any particular company's costs. Further, the results OCA used are nearly a decade old. (VZ St. 1.1 (Price Rebuttal) at 38-39).

at least $23 (or higher) as a safe harbor, but without tying it to any entitlement to increased USF subsidies.[16]

3. The Record Does Not Support Any Business Rate Cap

The RLECs contend that there was an unspecified "proportional" single line business rate cap as part of the settlement adopted by the *Global Order* and that this unspecified "corresponding" business rate cap is a "rate change limitation" that is "law in Pennsylvania" by virtue of Section 3015(g). (PTA Main Br. at 27-28). Embarq and the OSBA also refer to a corresponding business rate cap in the pre-Act 183 orders. But none of these parties even attempts to address the testimony submitted by Verizon relating to the RLECs' business rates. Their Main Briefs do not support any particular business rate level as a reasonable "cap" on RLEC business rates – nor could they do so since there is absolutely no record evidence to support such an argument. As Verizon explained in its Main Brief, the RLECs themselves conceded that the national average single line business rate was $36.59 in 2007 (a figure that itself is likely higher today),[17] which is ***$10 higher than*** Embarq's alleged cap of $26.23 and ***$13 higher than*** D&E's alleged cap $23.58 and considerably higher than the RLECs' current business rates. (VZ Main Br. at 20-21). The RLECs advanced no argument that would support requiring other carriers, including direct competitors, to reimburse the RLECs to allow them to avoid increasing business rates that are presently far below the national average – an absurd and unsupportable proposition. Given that the RLEC business rates are so far below those of other carriers, there is no need

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16 Embarq argues that the Commission need not take any action and should simply leave the $18 rate cap in place (presuming that it has not already expired). (Embarq Main Br. at 2). But now that the Commission has developed a record on the issue, it cannot ignore that record and continue to apply a rate cap that is so demonstrably ***not*** supported by the evidence.

17 PTA St. 1R (Laffey Rebuttal) at 22.

even to consider a "cap" on business rates. The record unquestionably lacks substantial evidence to support a requirement that other carriers fund RLEC revenue opportunities to avoid ***business*** rate increases. The RLECs should be permitted to make their annual inflation-based rate increases to business rates in due course as contemplated by Chapter 30 and their alternative regulation plans (and as discussed above the RLECs should also be free to make a reasonable allocation of the increases to their residential rates, rather than forced to increase only business rates by the enforcement of an $18 residential rate cap that is not supported by any evidence). The Commission must look to maximizing the RLECs' ability to raise revenue from their own end users through noncompetitive services rate increases rather than looking to impose a system of revenue subsidies from other carriers.

B. The Commission Has Authority To Perform A "Just And Reasonable" Rate Analysis Of The RLECs' Basic Rates

One of the questions set for investigation was whether the Commission has the authority under Chapter 30 and other relevant provisions of the Public Utility Code to perform a "just and reasonable" rate analysis of the RLECs' residential rates for basic local exchange services. The parties take differing views on this legal question. PTA and Embarq argue that any rate that results from performing the calculations in the inflation-based formula from the alternative regulation plan is by definition "just and reasonable." As Embarq stated, "[i]f the rates are consistent with that plan, they are by definition just and reasonable." (Embarq Main Br. at 2). Similarly, the PTA argues that "the Commission's administrative discretion under the general 'just and reasonable' standard is limited to the express terms of the alternative regulation plans that it has approved." (PTA Main Br. at 39). The OCA disagrees, asserting that "the Commission has the authority and obligation pursuant to Section 1301 to assure that rural ILECs only charge rates that are just and reasonable." (OCA Main Br. at 53). According to OCA, "Section 3019(b) specifically provides that an ILEC's Chapter 30 plan does not supersede Section 1301." (*Id.* at 54).

This Commission has already sided with OCA's reading of the pertinent statutory provisions, recognizing that in reviewing annual price change filings under alternative regulation, "the Commission still has the statutory mandate, authority and responsibility under 66 Pa. C.S. § 3019(h) to adjudicate whether the proposed rate changes are just and reasonable and non-discriminatory respectively under sections 1301 and 1304 of the Public Utility Code, 66 Pa. C.S. § 1301 and 1304."[18] Under 66 Pa.C.S. § 3019(h), an alternative regulation plan supersedes all conflicting laws relating to rates and ratemaking ***except***, among others, "section[] 1301 (relating to rates to be just and reasonable)." Similarly, under 66 Pa. C.S. § 3015(g), "[n]othing in this chapter shall be construed to limit the requirement of section 1301 (relating to rates to be just and reasonable) that rates shall be just and reasonable."

This very legal issue is presently before the Commonwealth Court in D&E's appeal of the Commission's orders disallowing its attempt to implement its 2006 price change opportunity by increasing its already excessive switched access rates, where D&E has advanced the same limited interpretation of "just and reasonable" that the RLECs advance here.[19] This Commission, through its Law Bureau, rejected as "incorrect" the RLECs' contention that "the Commission's authority with respect to a telephone company subject to

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18 *Commonwealth Telephone Company PSI/SPI Filing for Year 2005*, No. R-00050551 (Opinion and Order entered August 31, 2005) at 7.

19 The point of the RLECs' appellate argument (which the Commission and Verizon have opposed) is to claim that the Commission had no authority to forbid D&E from increasing its switched access rates, no matter how unreasonable or unjust the resulting rates might be from the perspective of the ratepayers. But if that were the law, then the Commission similarly would not have the authority to forbid the RLECs from increasing their residential rates no matter how the resulting rate would impact the ratepayer, and hence no authority to impose rate caps.

alternative regulation is limited to reviewing whether the company correctly calculated the additional revenue permitted by its price change formula and whether the proposed rate change violates an explicit term of the plan or any preexisting Commission orders or regulations," and the Law Bureau asserted that "[t]he Legislature clearly preserved the Commission's authority to protect ratepayers of noncompetitive and protected services by disallowing any rate increase found to be unjust and unreasonable under 66 Pa. C.S. § 1301, even if that increase is proposed as part of an annual price change filing." (VZ St. 1.1, Exhibit 1 (PUC Commonwealth Court Br.) at 23). As the Commission's brief explained,

> [T]he D&E Companies would read out of the statute those portions of Section 3019(h) and 3015(g) that expressly preserve the Commission's authority over all noncompetitive rates under Section 1301. If the Legislature had intended to confine the Commission's authority only to determining if a rate change complies with the terms of the alternative regulation plan and pre-existing "rate limitations," there would have been no need for the statute to preserve the Commission's authority under Section 1301 to determine if these rates are just and reasonable, and instead it would have clearly eliminated that authority. The D&E Companies' counterintuitive reading has the Legislature preserve Section 1301 with one breath, only to take it away with the next. This reading controverts the statutory construction act, which requires that "[e]very statute shall be construed, if possible, to give effect to all its provisions." 1 Pa.C.S. § 1921.

(*Id.* at 26)

But while this Commission continues to have the authority to ensure that end user rates are just and reasonable, its decisions in that regard must be based on substantial evidence. In light of the evidentiary record here, it would be arbitrary and capricious for the Commission to adopt the OCA's position presuming that any RLEC residential rate above $18 is by definition unjust and unreasonable. Even if it were appropriate to attempt to set a sweeping rate cap that establishes a uniform "just and reasonable" residential rate level for all RLEC residential rates, the record evidence does not support setting that level at $18.

The record only supports either setting no cap at all or setting a benchmark no lower than $23 as a safe harbor, where rate increases up to that point would automatically be deemed just and reasonable while any attempt to exceed the benchmark would be subject to a just and reasonable analysis on a case-by-case basis.

II. UNIVERSAL SERVICE FUND

A. The RLECs Are Not Automatically Entitled To Use The USF To Fund Their Annual Chapter 30 Revenue Increases

Rather than attempting to defend on its merits their proposed huge expansion of the USF, the RLECs and OCA argue that the Commission has no choice but to provide the USF funds they demand and thereby to force other carriers to subsidize the RLECs' annual revenue increases. They contend that this result was pre-ordained by the Commission's adoption of RLEC-authored settlements and alternative regulation language that pre-dated Act 183 and the reference back to those orders in the RLECs' current alternative regulation plans. According to the PTA, "[t]he RLECs are entitled by law to obtain support from the PAUSF for rate increases that exceed the cap." (PTA Main Br. at 39).

The RLECs start out with out-of-context snippets of language from the *Global Order*, establishing a "rate ceiling" of $16 "until December 31, 2003" and stating that "as set forth below" if rates over $16 are found to be just and reasonable then "the revenue associated with the difference between the rate ceiling and the approved rate will be recovered from the PA USF." (PTA Main Br. at 14) (citing *Global Order* at 201). According to the RLECs, this language demonstrates that the *Global Order* contemplated a general entitlement for new USF subsidies if an RLECs' plan allowed for an overall revenue increase. But if one looks at the details of the order, first, the Commission was referring to the situation where an RLEC's existing rates were over $16 and were proposed to be reduced as part of the rebalancing at issue. Second, this phrase was modified by "as set forth below," and the Commission went on to quote on the next page that "the RTCC . . . proposed to create a USF in order to compensate the RTCC to reduce their toll and access rates," and it is clear that the Commission only contemplated the USF being used to support a "rate rebalancing" of access and toll rates that is "revenue neutral," not overall revenue increases. (*Global Order* at 202). In fact, the USF settlement adopted by the *Global Order* made quite clear that "[a]ll revenues received from the Fund, after the deduction therefrom of any contribution made by a Fund Recipient to the Fund, ***shall*** be used to rebalance, on a revenue neutral basis, the rates/revenues derived from access and/or other services according to the rules set forth herein."[20]

The RLECs next rely on a settlement between the Commission and the RLECs from 2000, relating to the RLECs' withdrawal of their appeal of the *Global Order*. They suggest that this settlement somehow promised that in exchange for withdrawal of the appeal, the RLECs would be entitled to offsetting USF funds if they chose to increase rates over the applicable rate cap in a general revenue increase under the operation of their alternative regulations plans, by stating that "in the event that intrastate rate increases and/or revenue neutral rate rebalancings" results in rates over $16 then the RLECs "are permitted to recover the difference from the interim Pennsylvania USF." (PTA Main Br. at 15, citing Settlement attached as PTA Exhibit JJL-4). But as discussed above the USF plan adopted by the *Global Order* on an "interim" and "temporary" basis was expressly limited to the purpose of assisting to fund access or toll rate rebalancings, to reduce the magnitude of the end user rate

[20] *Global Order* Appendix II, Small Company Universal Service Fund Settlement, Appendix A at II.B (attached as Verizon St. 1.0 (Price Rebuttal), Exhibit 2 (emphasis added)). The 2003 USF plan similarly stated that "[a]ny approved future increases in rates above the $18.00 rate cap for any ILEC shall also be recoverable from the USF under the exact same terms and conditions as approved in the *Global Order*," thus incorporating that same limitation. (*Id.*, Exhibit 3)

increases required to keep the rebalancing revenue ***neutral.*** The language of this 2000 settlement cannot be read to expand and alter the *Global Order* to allow revenue ***positive*** draws on the USF, but rather must be read in the context of the Commission's reasonable understanding and expectations based on the law of alternative regulation as it existed at the time, under which large annual revenue increases outside of the access or toll rate rebalancing context were highly unlikely. Before 2004 the alternative regulation plans contained large inflation off-sets, which made it unlikely that the formula would result in the entitlement to increase overall revenue. When the new Chapter 30 was enacted in 2004, it eliminated the inflation off-set portion of the alternative regulation formula for RLECs, making it much more likely that large revenue increases would be permitted each year. It cannot be the case that by approving vague and general language referring to USF recovery from an "interim" fund nearly 10 years ago under a very different old Chapter 30 legal framework, that this Commission and other carriers are now bound to write the RLECs a blank check of unlimited USF funding for their hefty annual revenue increases under the new Chapter 30. Neither the Commission nor the other carriers that consented to the creation of the USF in 1999 and to its continuation in 2003 could have consented to the interpretation of the USF that the RLECs advance now.

The fact that some of the RLECs' Chapter 30 plans refer to the *Global Order* rate cap and recovery of revenues from the USF also does not mean that the Commission is now bound to provide unlimited USF funding to the RLECs. The RLECs contend that their plans are "equivalent to statute and not subject to unilateral PUC alteration," (*Id.* at 23), which may be correct in theory, but the plans as written do not establish the right to USF funding that the RLECs demand. For example, the plan language quoted in the PTA's Main

Brief, (PTA Main Br. at 21), refers to a "transitional" USF that was projected to terminate on December 31, 2003, and makes clear that it is simply incorporating whatever rights might have existed under the *Global Order* and July 2003 USF plans, not altering and expanding those rights.

If the RLECs' argument were correct, then this Commission and the other carriers that participated in the various pre-Act 183 settlements bought the proverbial "pig in a poke." While they thought they were signing on for "interim" and "transitional" funding directly tied to the revenue neutral rate rebalancings expected under the old Chapter 30, the RLECs contend that what they really agreed to was to provide unlimited and ever-increasing new revenue to the RLECs every year in perpetuity. The Commission's Law Bureau attorneys rightly told the Commonwealth Court that this "argument . . . that the Commission has no choice but to reimburse the [RLECs] from the PaUSF is ***absurd***." (VZ St. 1.1 Exhibit 1 (PUC Commonwealth Court Brief) at 21) (emphasis added). As the Commission's brief explained, "[t]he rate caps were established in the context of setting parameters for rate rebalancing to reduce access and intraLATA toll rates, not as a broader limitation on a rural ILEC's implementation of their annual revenue increase opportunities under their alternative regulation plans." (*Id.* at 36).

Because the USF was clearly intended for this limited purpose of supporting rate rebalancing, the Commission's USF regulations contain no reference to using the USF to fund general rate or revenue increases, under the LEC's alternative regulation plan or otherwise, and instead make clear that the "purpose of the Fund is to maintain the affordability of local service rates for end user customers while allowing rural telephone companies to reduce access charges and intraLATA toll rates, on a revenue-neutral basis, thereby encouraging greater competition." 52 Pa. Code § 63.161(3). The regulations do not contain ***any*** provision allowing for USF reimbursement if a fund recipient's retail rates exceed any particular benchmark and do not provide for the USF to be used to fund RLEC annual revenue increases.

The RLECs contend that the "Pa USF continues until there is a further rulemaking," (PTA Main Br. at 18), but if that is the case then only those aspects of the USF actually codified in the regulations survive. The regulations notably do not mention the alleged rate caps or the use of the USF to fund annual revenue increases that the RLECs advocate here. Clearly the RLECs have no pre-existing "entitlement" to the USF reimbursement they seek, but rather are asking the Commission to create a new and different USF that could potentially dwarf the size of the current USF, to be used to increase RLEC revenue rather than to support revenue-neutral rebalancings. This proposal would be harmful to consumers and is not supported by the record.

But even if the RLECs retain some hypothetical entitlement to USF funding when their basic residential and business rates reach certain "cap" levels – which they do not for the reasons discussed above – they have already conceded that this Commission is free to modify the cap level that triggers this entitlement. As discussed above, the record does not support a residential rate cap lower than $23 and supports no business rate caps. Accordingly, the Commission need not address the RLECs' theoretical "entitlement" to make USF claims if it finds that the RLECs are still able to implement their annual revenue increase opportunities by increasing residential and/or business rates based on eliminating or increasing any such caps.

B. The Commission Cannot Rely On The RLECs' Vague And Unsubstantiated Claims Of Hypothetically Higher Costs As Record Support For USF Expansion

In case the Commission does not agree that the RLECs are automatically entitled to new USF subsidies, the RLECs also argue that they need these additional USF subsidies because they face hypothetically higher costs to serve customers in rural areas. But they have presented no evidence upon which the Commission could conclude that the RLECs are not already able to meet their operating obligations with existing revenues and federal and state USF subsidies. Accordingly, if need for the subsidies were a relevant factor, the RLECs have not met their burden of proof.

As an initial matter, even if a particular RLEC had come forward with proof that it is not able to meet its operating obligations under alternative regulation with its current sources of revenue, then the appropriate remedy would not be to require other carriers to subsidize a failing RLEC business plan with new USF subsidies without further examination. Rather, if an RLEC asserts that it cannot stay in business under alternative regulation without additional external subsidies, then that RLEC should return to rate-of-return regulation and submit itself to a comprehensive rate case – but it should not be entitled to increase its subsidies from other carriers based on vague claims and generalities. (VZ Main Br. at 29). But in any event, the lack of any competent proof that any of the RLECs need new subsidies is basis alone to reject the RLECs' arguments because it shows that there is no real problem that needs to be addressed.

Again, the RLECs wish to have it both ways. They argue that the Commission should force other carriers to subsidize them based on the general assertion that RLECs face hypothetically higher costs, but they do not want to open themselves up to an actual examination of their costs and finances. In fact, the witnesses conceded that they deliberately did ***not*** look at the RLECs' costs or profits and could not opine as to whether the new USF subsidies were actually needed. As Mr. Laffey – an outside consultant presented as the PTA's only witness – explained, he did not "study the revenues or the costs of any of the individual PTA companies" on whose behalf he testified and he "did not form any conclusion as to whether" any particular RLEC's "overall costs exceed their overall revenues for Pennsylvania regulated services." (Tr. at 477-478). Similarly, OCA's Dr. Loube conceded that he did not examine and does not know whether the RLECs could meet their operating obligations without this additional USF support. (Tr. at 105-06, 110-111).

Instead of actual evidence, the RLECs rely on vague platitudes, such as claiming that RLECs "are exceedingly rural," (PTA Main Br. at 6), that the "RLECs continue to be the sole guarantors of universally available voice service in rural Pennsylvania," (*id.*) and that "the sparse population densities and high costs of service [have] rendered telephone service less profitable." (*Id.* at 40). But as Verizon explained in its testimony and Main Brief, the RLECs' USF proposal is unprecedented and potentially devastating to Pennsylvania telephone carriers and their customers. The RLECs' proposal should not be undertaken based on nothing more than the bare and unsubstantiated assertion that the RLECs face unquantified "high costs" in some unspecified locations.

The PTA asserts that its "companies collectively serve the most rural areas (i.e., less dense) of Pennsylvania" and that 100% of RLEC lines classified as rural. (PTA Main Br. at 51). But simply because a company serves rural territories does not establish that it cannot serve its customers adequately without increased subsidies from other carriers. To date, the RLECs have provided service to their customers without the additional subsidies they now seek. They have presented no evidence demonstrating that they are in jeopardy of not being able to continue providing adequate service without a new infusion of cash from the USF. Indeed, Embarq represented to this Commission to secure approval of its spin-off from Sprint that it would "continue to have the financial capability to invest in its network, generate sufficient cash to pay all expenses and pay a dividend to its shareholders," even if it had to bank nearly $9 million in upcoming revenue increase opportunities. (VZ Main Br. at 32). The Commission just approved another Embarq transaction that is projected to result in nationwide merger synergies "estimated to reach $400 million annually."[21] Similarly, two of the other mid-tier RLECs — D&E and Windstream — have filed an application to merge their operations to achieve savings and synergies. Further, where an RLEC actually faces higher costs under FCC criteria, the RLECs already receive federal USF support for serving high-cost areas, and they have presented no evidence demonstrating that this support — in conjunction with their other regulated revenue sources — is insufficient to allow them to serve their customers adequately.

The RLECs vaguely assert that they face "increased costs," (PTA Main Br. at 7), without any real detail. As Mr. Price explained, the claim that the RLECs "need" additional USF subsidies rests on a fiction – that is, that they only provide service to high cost customers. That clearly is not the case. Even if one accepts the RLECs' unsubstantiated premise that certain customers in remote areas of RLEC territory who purchase only stand-alone basic service do not pay enough to cover the costs of serving them, despite the RLEC's receipt of federal high-cost USF support (an assertion on which there is no

[21] *Joint Application of The United TelephoneCompany of Pennsylvania LLC /b/a Embarq Pennsylvania and Embarq Communications, Inc. For Approval of the Indirect Transfer of Control To CenturyTel, Inc.*, Docket No. A-2008-2076038 (Opinion and Order entered May 28, 2009) at 21.

evidence), that still does not prove that the RLEC needs additional subsidies from other carriers to serve adequately its overall customer base. (VZ St. 1.2 at 8). Further, the RLECs unsubstantiated prediction that they might lose the higher-revenue, lower-cost customers and be left serving only the more expensive customers is not a basis to create a whole new USF scheme. The RLECs have not provided any evidence to support this claim, and because the entire retail telecommunications marketplace is highly competitive the other carriers that would be forced to pay into the USF to subsidize the RLECs also face the same theoretical risk of losing their most profitable customers.

The RLECs' attempt to contrast themselves with Verizon also does not remedy their lack of any real evidence about their own operations. The RLECs contend that the Commission should ignore their scale, scope, finances and other available sources of income and consider only the fact that ***some*** of their service territory is purportedly high cost and pretend that all their customers purchase nothing other than stand-alone basic service. But with the same breath, the RLECs contend that because of ***Verizon's*** scale and scope it can easily afford its current payments to the USF. (Embarq Main Br. at 16). If the Commission were to adopt the RLECs' theory that the only relevant consideration is the "high cost" of rural territory, then the Verizon ILECs should be the largest ***recipients*** of state USF contributions, not the largest contributors because the Verizon ILECs serve more rural access lines in Pennsylvania than all of the RLECs put together. (Verizon St. 1.2 at 9). But Verizon does not receive and is not asking for state USF subsidies, and most of the RLECs should not be receiving those subsidies either. Similarly, PTA complains that its companies do not "have the same level of business customers as Verizon" and no "internal source against which to counter balance the high cost of rural residential service." (PTA Main Br.

at 7-8). But PTA supplies no evidence to support this claim. Simply assuming that Verizon is able to cover its overall cost of providing service does ***not*** establish that the RLECs are not ***also*** able to recover their overall costs.[22] Under alternative regulation, an RLEC's rates are not set based on its costs and it is not required to disclose its overall profits, but the fact that each of the RLECs is able to operate and service its customers is reason enough to conclude that they are able to cover their operating costs, and they have not demonstrated otherwise. The RLECs' references to Verizon's size and scope are nothing but an irrelevant attempt to divert attention from their own failure to prove their case – a case that is about the RLECs, not about Verizon.

Embarq is the only RLEC that attempted to present company-specific testimony about its allegedly higher costs of providing service, but even Embarq relies on purely hypothetical arguments that suffer from the same flaws discussed above, and does not actually prove its claims. According to Embarq, "[t]he $18 rate cap does not come close to covering the cost to Embarq of providing basic local exchange services" and only "recovers well under half of Embarq's estimated average monthly cost per line." (Embarq Main Br. at 15). But these claims are based on the testimony of Ms. Lounderholm, which Verizon thoroughly rebutted. As Verizon's Mr. Price explained, it is an absolute fiction for Embarq to pretend that the only revenue available to cover its "costs" per line is the $18 "basic" rate. In fact, the record shows that Embarq's average operating revenue per line is $76.88 per line, which would include all of Embarq's reported revenue from all services, its current federal and state USF subsidies as well as access revenue, all of which also support

22 PTA asserts based on a thirteen year old pleading that Verizon's "urban customers subsidize its rural customers" (PTA Main Br. at 52), but even if this claim were still true (an unproven fact) it would be irrelevant because Verizon is not seeking state USF subsidies in this investigation.

Embarq's operating costs. (VZ St. 1.2 at 11). Even if one looked only at average customer bill information (which excludes revenue from other services and from subsidies), Embarq's average monthly revenue per household as reported in its third quarter 2008 form 10-Q filed with the Securities and Exchange Commission was almost $57. (*Id.*). Both of these figures well exceed what Embarq claims is its cost per line. In arguing that "the $18 residential rate cap benchmark is not enough to recover" Embarq's alleged costs and that additional USF subsidies should be provided, Embarq is trying to secure the benefits of rate-of-return regulation for its basic service rates without submitting itself to the kind of examination of its regulated costs and revenues that would be required of a company that is subject to rate-of-return regulation. Under alternative regulation, Embarq's costs of providing service are not relevant, and Embarq has provided no justification to increase its already sizeable subsidies from the USF.

C. Allowing The USF To Be Expanded To Fund The RLECs' Annual Chapter 30 Revenue Increases Would Have Anti-Competitive And Other Adverse Effects

Notably, the RLECs do not deny that their proposal could easily cause the current USF to snowball to a huge size that dwarfs the present $30 million per year already provided. (VZ Main Br. at 23-24). The RLECs also do not even attempt to justify why other carriers should be required to supply them with a risk-free and guaranteed revenue stream to replace the end-user rate increases that the Legislature intended to be exercised subject to market forces and incentives.

The RLECs also do not meaningfully address Verizon's testimony regarding the harm to consumers that would result if the RLECs' plan were adopted. The customers of the companies forced to finance the ever-expanding USF would be denied the benefits of revenue that otherwise could have been used to improve the companies' products, services, or networks, or even to reduce rates. Those companies might even be required to increase some rates in order to carry on their everyday operations and meet their ever-increasing USF burden – particularly if the USF snowballs to tens or hundreds of millions of dollars. Telecommunications companies that might otherwise have chosen to invest in Pennsylvania could choose to take their business elsewhere, particularly as the USF burden becomes higher and higher as a percentage of revenue, leaving Pennsylvanians with fewer competitive options. Customers in the RLEC territory will also suffer as their opportunities for competitive alternatives will be diminished over time, because any carriers that wish to come in and compete with the RLEC will have to compete with heavily subsidized operations and either may choose not to compete at all or may not compete as effectively. These RLEC customers might also be deprived of service, product and network innovation by the RLEC itself, because an RLEC that is guaranteed a constant, ever-increasing and risk-free stream of revenue from a source other than its customers, and also faces a diminished competitive threat, will naturally have less incentive or need to deploy innovative products and services to retain and attract customers. (VZ Main Br. at 24-26).

The Commission should not encourage the RLECs to rely on anticompetitive business plans that depend more on generating revenues from other carriers – and their customers – than from their own end users. The RLECs complain that "[m]ost of the RLECs have completed their broadband service commitments as of December 31, 2008 as required" and "have every right to expect that the ratemaking provisions of their Chapter 30 Plan will be permitted to operate as approved," as if the Commission would be reneging on its part of the bargain if it did not force other carriers to divert revenue to the RLECs without regard to need. (PTA Main Br. at 44). But neither the Legislature nor this Commission ever promised that other carriers would serve as the source of new revenue under alternative regulation. Verizon is not suggesting that the Commission should deny the RLECs the opportunity provided by alternative regulation to secure new revenue by increasing their end user rates. It should permit them to exercise their rights to increase business rates to the extent they wish to do so and also to increase residential rates – either with no cap or with a substantially higher cap and subject to the safe harbor mechanism described above. But the RLECs have no right to have the Commission rewrite the statute to force other carriers to supply a guaranteed stream of new revenue to the RLECs and thereby undercut the incentive scheme that is the heart of alternative regulation.

The RLECs and OCA also fail to address or attempt to refute the discussion in Verizon's testimony regarding the inequity of permitting the RLECs as a group — and particularly the mid-tier RLECs — to continue to receive a constant $30 million per year from the current USF, which in effect provides the RLECs with a windfall due to declining access line counts and access minutes-of-use. (VZ Main Br. at 33-35). Based on Verizon's unrebutted evidence, the Commission should take immediate steps to decrease the current USF, which was only intended to be a temporary and interim "mechanism to facilitate the transition from a monopoly environment to a competitive environment" and not a permanent entitlement.[23]

CONCLUSION

For the foregoing reasons, the Commission should conclude as a result of this investigation that:

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[23] *Global Order*, slip op. at 135.

(1) RLECs should not be permitted to use the USF to obtain annual revenue opportunities under their alternative regulation plans, but rather must either secure that revenue from their own operations or bank the opportunity;

(2) it is not necessary to impose a cap on RLEC residential rates;

(3) alternatively, if a residential rate cap is needed it should be set above \$18 – and no lower than \$23 – and should serve as a safe-harbor for review of RLEC rates and not under any circumstances as a starting point for RLEC USF claims;

(4) the evidence does not support any cap on RLEC basic business rates;

(5) the Commission should not adopt a "needs-based" test to increase RLEC support from the USF, but rather if an RLEC demonstrates that it is not able to meet its operating obligations under alternative regulation, the remedy should be a return to rate-base, rate-of-return regulation and a full rate case; and

(6) the current USF should be reduced at least proportionate to the line loss experienced by each RLEC since the inception of the fund, and the Commission should examine further reducing or eliminating the current USF.

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