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Via Electronic Filing

Rosemary Chiavetta, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street, 2nd Floor
Harrisburg, PA 17120

Re: AT&T Communications of Pennsylvania, LLC
v. Verizon North LLC and Verizon Pennsylvania Inc.
Docket No. C-20027195

Dear Secretary Chiavetta:

Enclosed please find the Main Brief of the Verizon Companies, filed on behalf of Verizon Pennsylvania Inc. and Verizon North LLC, in the above captioned consolidated matter. Because the Main Brief includes certain Proprietary information the Public Version of the Main Brief is being e-filed, with the Proprietary Version being provided via overnight delivery.

Please do not hesitate to contact me if you have any questions.

Very truly yours,


Suzan D. Paiva

SDP/meb
Enc.

VIA E-Mail and First Class U.S. Mail
cc: The Honorable Cynthia W. Fordham
Attached Certificate of Service

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of Verizon's Main 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 16th day of August, 2011.

VIA E-MAIL and FIRST CLASS U.S. MAIL

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**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

**AT&T Communications of
Pennsylvania, LLC**

v.

**Verizon Pennsylvania Inc. and
Verizon North LLC.**

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Docket No. C-20027195

MAIN BRIEF OF VERIZON

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NON-PROPRIETARY VERSION

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INTRODUCTION

Verizon has presented extensive evidence that pricing constraints and regulatory burdens imposed uniquely on Verizon are contributing to substantial losses on services whose rates are under this Commission's jurisdiction. The Commission should not require Verizon to unilaterally reduce its intrastate access rates further — when those rates already are well *below* what the Commission recently determined to be just and reasonable under Pennsylvania law — in the face of Verizon's asymmetrical regulatory burdens. These burdens include Verizon's continuing obligation to transfer tens of millions of dollars a year to other Pennsylvania ILECs through universal service fund payments and excessive access rates. Indeed, such a result would be particularly untenable given that: Verizon serves more rural customers and more rural geography than any of these other "rural" carriers; these other "rural" carriers have experienced fewer line losses; and (unlike Verizon) these other carriers have not presented any evidence that they are experiencing any financial distress, let alone that they are losing millions annually on the intrastate services regulated by this Commission.

But before the Commission reaches the merits of the issues in this proceeding, it should provide the parties a full opportunity to address the implications for this case of the ongoing Federal Communications Commission ("FCC") reform and any modifications that this Commission may make to the landmark order issued in the rural incumbent local exchange carrier access investigation on July 18, 2011 ("Access Order" or "Order") under reconsideration. The industry proposals filed at the FCC last month to reform intercarrier compensation and universal service, in marked contrast to the proposals before this Commission, recognize the crucial importance of regulatory

symmetry. The potential federal reform would eliminate the huge rate disparities that work solely to the disadvantage of Verizon's Pennsylvania customers because it would ensure that all rates across the country are brought into parity so that Verizon's Pennsylvania customers are not forced to subsidize carriers elsewhere around the state and across the country. In contrast, unilaterally imposing further reductions on Verizon would serve to further increase Verizon's already substantial losses on its intrastate services and reduce the revenues available to support continued investment in the state, while forcing customers to continue to ship subsidy payments to other carriers around the state and across the country — through high access charges payments and “net” contributions to the state and federal universal service funds — including such far-flung places as Texas and Mississippi. Given the procedural posture of this case and the unique circumstances presented, the most prudent and efficient course is for this Commission to refrain from issuing a decision in this case until the Commission can factor in both the FCC's expected ruling this fall and this Commission's own determinations on the petitions for reconsideration of the Access Order.

If the Commission nevertheless moves forward in this proceeding despite its unique posture and the stale record that fails to include information on continually-evolving and critical issues, the existing record conclusively establishes that reducing Verizon's switched access rates in isolation would be unlawful and bad policy. Constitutional, statutory, and public policy imperatives dictate that the Commission must ensure that Verizon has a reasonable opportunity to recover its costs for providing rate-regulated services — and that in doing so, the Commission may not consider revenues from competitive services or services beyond its jurisdiction. But Verizon's extensive

economic evidence demonstrates that its existing rate structure is no longer compensatory because the combination of intense competitive pressures and burdensome legacy regulation is causing substantial and growing losses on rate-regulated services. The Commission should not and cannot make this unsustainable situation worse.

Moreover, the Access Order — while not what Verizon advocates — establishes the reasonableness standard that now applies under Pennsylvania law and confirms that there is no basis to further unilaterally reduce Verizon’s switched access rates. Indeed, as noted above, Verizon serves more rural customers and more rural geography than any other carrier in the state, and there is no lawful basis for imposing larger reductions on Verizon than on other carriers. In the Access Order, the Commission rejected both the AT&T/Sprint argument that the other rural LECs should mirror their own interstate rates and the Verizon argument that the Commission should establish a single state-wide rate. Instead, the Commission established a switched access policy that “differs materially from those that have been adopted by the FCC in the past” (Access Order at 118) because it authorizes carriers to recover a substantial portion of their costs from other carriers. While we respectfully submit that that aspect of the policy adopted in the Access Order is erroneous, if the Commission confirms that standard on reconsideration, it must at the very least allow Verizon to maintain its switched access rates at current levels — which are *much lower* than the levels to be charged by most of the other rural LECs even after completing the four-year phase-in under the Access Order.

Sprint and AT&T ask the Commission to reduce Verizon’s switched access rates to interstate levels without regard to Verizon’s financial position and regulatory burdens, arguing that authorizing limited rate rebalancing would keep Verizon whole. The

Sprint/AT&T proposal would require the Commission to embrace the fiction that Verizon would have a realistic opportunity to recover the costs of its rate-regulated services, but the record shows that no such opportunity would exist. And the Commission cannot lawfully reduce Verizon's rates further when it already is losing millions annually on intrastate services, particularly while it continues to subject Verizon to archaic legacy regulatory burdens which contribute to those large ongoing losses.

I. This Proceeding Is Not Ripe for Commission Action.

The relevance to this proceeding of the landmark Access Order cannot be properly evaluated at this time. Given that the Order was issued after the record in this proceeding had closed, Verizon filed on July 11, 2011, a Petition to Reopen the Record for the limited purpose of taking additional evidence relating to how the factual and policy determinations in the Order apply to this case. However, because that petition was denied, a number of factual and policy issues relevant to this proceeding cannot be fully developed in post-hearing briefs.

Even AT&T has acknowledged the "ridiculousness" of a Commission policy "whereby Verizon's customers, including both the urban poor and the rural customers Verizon serves, are subsidizing the PTA companies, who, in some cases, serve more highly or comparably dense areas on average, and whose rates often are lower than what Verizon charges its customers."¹ It is uncontested that Verizon serves vast portions of sparsely populated areas in Pennsylvania and that it serves more rural customers than all of the so-called "rural" ILECs in the state combined; in fact, Verizon serves

¹ See Recommended Decision before Susan D. Colwell, *Investigation Regarding Intrastate Access Charges and IntraLATA Toll Rates of Rural Carriers and the Pennsylvania Universal Service Fund*, Docket No. I-00040105 (issued July 22, 2009), at 52 (citing AT&T Main Brief at 25-26) (explaining why a needs-based test is crucial for avoiding abuses of the state universal service system).

approximately one million rural customers in the state.² Any action that enlarges the differential treatment among carriers that serve rural customers even further would be untenable because it would be fundamentally arbitrary and contrary to basic principles of administrative and equal protection law.³

The pricing distortions caused by the lack of parity among carriers in Pennsylvania are remarkable. Companies literally *lose money* when terminating traffic to “rural” Pennsylvania carriers. Tr. at 424. That is because the long-distance price is driven downward by Verizon’s access rates, which are much lower than the RLEC average. So lowering Verizon’s access rates in isolation would literally *increase* the amount of money carriers lose every time they terminate traffic to RLECs. Even after the RLECs modestly reduce their switched access rates after the Access Order’s four-year phase-in period, substantial price distortions will persist because the RLECs will still charge composite intrastate switched access rates that are substantially higher than Verizon’s present composite rate.⁴ Such pricing distortions are the unfortunate outcome

² See Recommended Decision before Kandace F. Melillo, *Investigation Regarding Intrastate Access Charges and IntraLATA Toll Rates of Rural Carriers and the Pennsylvania Universal Service Fund*, Docket No. C-2009-2098380, *et al.* (issued July 27, 2010), Finding of Fact No. 86. The backup data for Judge Melillo finding was in VZ St. 1.1 (Mar. 10, 2010), at 22 n.16 (“[A]s of Decemer 31, 2006, Verizon PA and Verizon North together served over 1.1 million rural access lines in Pennsylvania based on the PUC’s classification of exchanges as rural for network modernization purposes”).

³ The Commission may not make rate decisions that are “arbitrary” or “unreasonable.” See, e.g., *Pittsburgh v. Penn. Pub. Util. Comm’n*, 370 Pa. 305, 315 (1952) (reversing Commission order where Commission had “arbitrarily ignored material and undisputed evidence”). To the contrary, a rate determination must be supported by “substantial evidence.” See *Lloyd v. Penn. Pub. Util. Comm’n*, 904 A.2d 1010, 1013 (Pa. Commw. Ct. 2006). The Commission may not simply engage in an abstract “mathematical exercise applying theoretical principles” but instead must base its determination on “the hard economic facts of life.” *Id.* The decision must be based on “a complete and thorough knowledge and understanding of all the facts and circumstances which affect rates and services.” *Id.* at 1016.

⁴ Quantification of this fact, of course, is not possible given Verizon’s inability to update the record.

of policy decisions to pursue access reform in a piecemeal fashion — an approach this Commission should avoid.⁵

Also, on August 11, 2011, the Commission granted reconsideration of the Order so that it can evaluate the merits of the reconsideration petitions filed by interested parties. The petitions for reconsideration raise various issues relating both to the reasonableness framework set forth in the Order and to the potential interplay between provisions of the Order and federal intercarrier compensation reform the FCC intends to enact this fall.⁶ As Verizon explained in its Opposition to the Petitions for Reconsideration and Stay, the Access Order is just a baby-step toward long-overdue reform of those carriers' extremely high access rates and should be implemented without delay. But given that Verizon's rates are already lower than the four-year-out end point of the Access Order, the need to update the deficient record here, and the potential that the applicable legal determinations may be modified on reconsideration of the Access Order, moving forward with this case would be a wasted effort. Any eventual order here would need to be revisited in the future upon an adequate record addressing this Commission's determinations in the "RLEC" proceeding.

Just as the Commission's deliberations here should account for any decisions on reconsideration of the Access Order, they should also consider the effects of the FCC's pending ruling on the proposed industry framework for intercarrier compensation and

⁵ Indeed, AT&T, despite its self-serving request here that the Commission divorce RLEC access rate issues from this proceeding, has elsewhere criticized state regulators that fail to apply comprehensive access policies across different carriers. See VZ St. 1.1 (Price/Mazziotti Rebuttal) at 43-44.

⁶ See Joint Petition for Limited Reconsideration and Stay filed by the Pennsylvania Telephone Association and the United Telephone Company of Pennsylvania LLC (Aug. 2, 2011) (raising various issues relating to the interplay between federal and state reform); Petition for Reconsideration and Clarification Submitted by AT&T (Aug. 2, 2011) (challenging, *inter alia*, the Commission's determination that the just and reasonable standard requires a flat Carrier Charge of \$2.50 per month).

universal service reform at the federal level. Verizon, AT&T, CenturyLink, and numerous other companies and carrier associations filed that consensus framework, comprised of complementary proposals for rate-of-return and price-cap carriers, at the end of July.⁷ The FCC called for comments on the proposals this month, and observers predict an FCC vote in the fall. Given this timing, Verizon expects that the Commission will — as it should — factor the FCC’s decision into any eventual ruling in this case. In contrast to the docket in which the Access Order — a final order — was issued, here the Commission has not even begun its deliberations on potential action with respect to Verizon’s access rates. Under the current schedule, briefing will not even be completed until September. So while it makes the most sense in the “RLEC” case to proceed to implement the required rate reductions, and then, if necessary, address the interplay between this Commission’s actions and federal reform, the most efficient course *here* is to account for the FCC’s ruling in the initial decision. In fact, the Commission specifically directed that any such FCC developments must be considered by the presiding officer in her initial decision in this case. Its order reopening this phase of the investigation the Commission directed that “the participating parties shall address and provide record evidence on the legal, ratemaking and regulatory accounting linkages between . . . any FCC ruling that may have an impact on intrastate switched access charges.”⁸

⁷ See Letter from AT&T, Verizon, CenturyLink, Frontier, FairPoint, Windstream, USTelecom, National Telecommunications Cooperative Association, OPASTCO, and Western Telecommunications Alliance, to FCC Commissioners, FCC Docket Nos. WC 10-90, et al. (July 29, 2011); *America’s Broadband Connectivity Plan*, filed with the FCC by Verizon, AT&T, CenturyLink, Windstream, Fairpoint, and Frontier on July 29, 2011.

⁸ *AT&T Communications of Pennsylvania Inc. v. Verizon North Inc.*, Docket No. C-20027195 (Opinion and Order entered May 11, 2011) at 22. The Commission also directed its staff “to continue monitoring the Federal Communications Commission’s *Unified Intercarrier Compensation*

Moreover, the differences in the respective situations of Verizon and the “RLECs” justify holding off any Commission action with respect to Verizon’s access rates — including Verizon’s large losses on rate-regulated services, its obligations to pay these other carriers millions of dollars a year in explicit and implicit subsidies, and the fact that their rates will remain well above Verizon’s current rates, even after implementation of the reductions required in the Access Order. Under these unique circumstances, the most prudent, efficient course is to refrain from issuing a decision in this case until the Commission can consider the effects of both the FCC’s pending ruling on intercarrier compensation and universal service funding and this Commission’s own determinations on the petitions for reconsideration of the Access Order.

Only the FCC can do what this Commission cannot even begin to do in this piecemeal proceeding — *i.e.*, rationalize and reduce all intercarrier compensation rates across the country in parallel to more appropriate levels. In contrast to the Access Order reform, which is a baby step consistent with the federal proposals, the proposals here to unilaterally reduce Verizon’s access rates would exacerbate existing rate differentials and create unnecessary and harmful price distortions. Given the circumstances here, a uniform approach is critical. Verizon is already operating at a substantial loss. And on the universal service side, Pennsylvania is already a large net contributor to the federal fund.⁹ Unilateral access charge reductions for Verizon alone, as some propose here,

proceeding and any other Federal Communications Commission proceeding or activity that may directly impact intrastate switched access charges.” *Id.* at Ordering ¶ 7.

⁹ See Bipartisan Energy and Commerce Leaders Release Information on Universal Service Fund, Press Release (July 27, 2011) at Request 1 (FCC Response to Universal Service Fund Data Request, State-by-State USF Support, Estimated Contributions and Estimated Net Dollar Flows and State-by-State Top 10 Recipients), page 1, *available at* <http://democrats.energycommerce.house.gov/index.php?q=news/bipartisan-energy-and-commerce-leaders-release-information-on-universal-service-fund>.

would compound that disparity by further forcing Pennsylvania consumers (Verizon customers) to subsidize other carriers around the state and around the country through access charge payments that Verizon cannot, in turn, collect. That situation represents a double-blow to Verizon customers. Not only would they be forced to pay more for no benefit, but subsidizing other carriers across study areas and state boundaries also reduces the funds available to Verizon to make network upgrades and other investments that would benefit the millions of Verizon customers in Pennsylvania.

II. Unilaterally Reducing Verizon's Switched Access Rates in Isolation Would Be Unjust and Unreasonable.

A. Constitutional, Statutory, and Public Policy Requirements Require the Commission to Ensure that Verizon Has an Opportunity to Recover its Costs of Providing Regulated Services.

As this Commission has acknowledged, the 66 Pa. C.S. § 1301 requirement that rates be “just and reasonable” is “coextensive with the federal constitutional standard for determining utility rates.” *Pennsylvania Public Utility Commission v. Philadelphia Gas Works*, 2001 Pa. PUC LEXIS 109 (Pa. Pub. Util. Comm’n issued Sept. 21, 2001), at *39. When establishing rates, “no applicable constitutional requirement is more exacting than the requirement of “just and reasonable rates.” *Public Advocate v. Philadelphia Gas Comm’n*, 544 Pa. 129, 139 (1996). Under Pennsylvania and federal law, a rate-regulated company “is entitled to rates, not per se excessive and extortionate, sufficient to yield a reasonable rate of return upon the value of property used, at the time it is being used, to render the services.” *Id.* at 140 (internal quotations omitted). A state regulator such as this Commission must ensure an adequate return on rate-regulated services — in this case Verizon’s basket of intrastate services that have not been classified by the Commission as competitive. *Smith v. Ill. Bell. Tel. Co.*, 282 U.S. 133, 149 (1930). The Commonwealth

Court has confirmed that the “just and reasonable” standard of Section 1301 continues to apply to rates regulated by the Commission as “noncompetitive,” including switched access rates, under Chapter 30’s alternative form of regulation. *Buffalo Valley Tel. Co. v. PUC*, 990 A.2d 67 (Pa. Commw. Ct. 2009).

Contrary to Sprint’s and AT&T’s assertion that the financial position of Verizon’s Pennsylvania ILECs is “irrelevant” to this Commission’s determination of a just and reasonable rate level (Appleby Direct at 26; Nurse/Oyefusi Direct at 6), regulators are required to consider the financial integrity of the regulated entity. As the U.S. Supreme Court explained in *F.P.C. v. Hope Natural Gas*, 320 U.S. 591, 603 (1944), the regulator must provide an opportunity to earn a return “sufficient to ensure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.” Moreover, “it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business.” *Id.* As the Consumer Advocate’s economist confirmed, it is “appropriate for this commission to concern itself with the financial integrity of the ILECs operating in Pennsylvania.” Tr. at 322. Accordingly, this Commission has repeatedly confirmed that a “just and reasonable” rate is one that appropriately balances the interests of both customers *and* regulated utilities. *See, e.g., Pennsylvania Public Utility Commission v. Lake Spangenberg Water Co.*, 2010 Pa. PUC LEXIS 25 (Penn. Pub. Util. Comm’n issued Mar. 2, 2010), at *23; *Pennsylvania Public Utility Commission v. United Water Pennsylvania, Inc.*, 2010 Pa. PUC LEXIS 11 (Penn. Pub. Util. Comm’n issued Feb. 8, 2010), at *15.

The fact that the Verizon ILECs are regulated under an alternative form of regulation in Pennsylvania does not absolve the Commission of its obligation to ensure that the rates it sets are just and reasonable. Although an agency has discretion to select a

ratemaking methodology, it must ensure that the end result of that methodology is that the regulated company is able to recover its costs and earn a reasonable return. “Under the statutory standard of ‘just and reasonable’ it is the result reached not the method employed which is controlling. It is not theory but the impact of the rate order which counts.” *Public Advocate v. Philadelphia Gas Comm’n*, 544 Pa. 129, 140 (1996) (quoting *Fed. Power Comm’n v. Hope Natural Gas*, 320 U.S. 591 (1944)). In accordance with that well-established principle, Section 3015 (g) specifically confirms that nothing in Chapter 30 shall be construed to limit the Section 1301 requirement that rates shall be “just and reasonable.” Accordingly, when establishing rates under Verizon’s alternative regulation plan and in this proceeding, the Commission may not disregard the statutory and constitutional just and reasonable standard.

B. Subjecting Verizon to Further Unilateral and Disproportionate Access Reductions Would Be Unjust and Unreasonable.

As Verizon has stressed in various forums, the end game for intercarrier compensation should be low industry-wide switched access rates for all carriers. The benefits of a unified intercarrier compensation system are widely recognized. For example, the industry consensus framework for reforming intercarrier compensation and universal service funding that is now before the FCC proposes to establish a default terminating rate of \$0.0007 per minute for all carriers nationwide. Establishing a single rate nationwide is the only way to ensure that customers of one state, such as Pennsylvania, are not forced to subsidize other carriers either elsewhere in that state or elsewhere in the country. In contrast, singling out one company for an onerous combination of rate caps and harmful regulatory burdens does not constitute a reasonable interim step towards comprehensive reform. To the contrary, based on the particular

circumstances relevant to Verizon's ILECs in Pennsylvania, including the evidence of financial distress and massive line losses, it would be unjust and unreasonable to require Verizon alone to reduce its switched access rates to levels well below what is just and reasonable for other ILECs.

1. Verizon Loses Millions Of Dollars in Pennsylvania.

Verizon presented a cost study showing that its costs for providing R-1 and B-1 services (which, along with switched access, are the primary services that remain rate-regulated in Pennsylvania) exceed the revenue Verizon earns from those services by **[BEGIN VERIZON PROPRIETARY]** **[END VERIZON PROPRIETARY]**. *See* VZ St. 1.0 (Price/Mazziotti Direct) at 22-33; VZ Direct Exhibit D & E. Those heavy losses on basic local service are causing Verizon to lose money on the basket of services that are rate-regulated: even under the highly conservative assumption that *all* revenue from Verizon's switched access services constitutes a subsidy to R-1 and B-1 services (in other words, not considering any costs for the provision of switched access service), Verizon's losses on the provision of rate-regulated services are nearly **[BEGIN VERIZON PROPRIETARY]** **[END VERIZON PROPRIETARY]** annually. *Id.* at 29; VZ Direct Exhibit D. In other words, Verizon is incurring significant losses on the overall basket of rate-regulated services. *See* VZ St. 1.1 (Price/Mazziotti Rebuttal) at 18.

Regardless of how one views the economic evidence, the inevitable conclusion is that Verizon is losing money and experiencing substantial financial distress. The financial statements Verizon Pennsylvania Inc. prepares for its bondholders¹⁰ and the

¹⁰ *See* VZ Rebuttal Ex. C-2.

annual reports it provides to this Commission¹¹ both confirm that Verizon is under substantial and worsening financial distress in Pennsylvania. The bondholder reports — which are prepared under generally accepted accounting principles and are audited by Ernst & Young — show a net loss of \$18 million in 2009 that worsened to *\$122 million* in 2010, and show that operating income declined from under \$100 million in 2009 to virtually zero in 2010.¹² The annual reports filed this Commission — on which the Commission relies for a “meaningful review of a company’s financial circumstances”¹³ — similarly show a net loss of \$78 million in 2009 which worsened to *\$187 million* in 2010, and they show that net operating income worsened from an insipid \$31 million in 2009 to negative \$57 million in 2010.¹⁴ Those substantial losses in recent years are the culmination of a decade-long downward spiral in Verizon’s financial performance in Pennsylvania.¹⁵

All of the varied evidence presented this proceeding (*e.g.*, cost study, audited bondholder reports, annual reports) points to the same result regardless of the methodology employed (*e.g.*, TSLRIC cost model, GAAP accounting, regulatory accounting) and regardless of the slice of activities analyzed (*e.g.*, intrastate regulated services, consolidated operating income, net income). The inevitable conclusion is that

¹¹ See VZ Rebuttal Ex. C-1.

¹² See VZ Rebuttal Ex. C-2, p. 3.

¹³ Pursuant to 52 Pa. Code § 63.36, each year Verizon PA and Verizon North file a balance sheet and income statement as well as other information required by the Commission. According to the Commission, the purpose of this reporting is to allow “the Commission to undertake a meaningful review of a company’s financial circumstances to fulfill our statutory duty of requiring reasonable, safe and reliable telecommunications service.” *PUC Filing and Reporting Requirements on Local Exchange Carriers*, Docket No. M-00041857 (Opinion and Order entered October 5, 2005) at 16. See also *id* at 13, n. 38 (acknowledging OCA’s comment that the Commission must review the annual reports to “evaluate the [] financial health” of local exchange carriers)

¹⁴ See VZ Rebuttal Ex. C-1.

¹⁵ See VZ St. 1.0 (Price/Mazziotti Direct) at 20; see also VZ Direct Ex. B.

Verizon is losing money on its Pennsylvania operations.¹⁶ That is the economic backdrop against which the Commission must evaluate proposals that Verizon be required to unilaterally reduce its switched access rates without corresponding relief from the regulatory constraints and burdens that are causing its losses.

2. There Is No Evidentiary Record Supporting Preferential Treatment for Other Rural Carriers.

Given Verizon's unique circumstances and the framework established for the "rural" carriers in the state, Commission action to unilaterally further reduce Verizon's switched access charges would be unjust and unreasonable. The Access Order concludes that a just and reasonable switched access rate under the Commission's interpretation of Pennsylvania law is one where each LEC mirrors the usage-based switched access rate elements in its interstate tariff, but maintains a \$2.50 per month Carrier Charge. Accordingly, that framework establishes the access rate level under Pennsylvania law that

¹⁶ There is no serious dispute about the fact that Verizon's overall wireline operations in Pennsylvania are unprofitable. Verizon's witnesses devoted an entire section of their direct testimony to this key fact (VZ St. 1.0 (Price/Mazziotti Direct), Section IV-B), and no party responded to this testimony in their subsequent direct testimony. Verizon's witnesses then reiterated this point and updated the financial information in their rebuttal testimony. See VZ St. 1.1 (Price/Mazziotti Rebuttal), Section III-B. Sprint alone purported to analyze Verizon's financial evidence, engaging the issue for the first time in its surrebuttal testimony. But the Sprint witness admitted on cross examination that the *only* analysis he did involved observing that the wireline operations of Verizon Pennsylvania ILECs' *parent* company — which include operations in *other states* and *other countries* — may be doing better financially than Verizon's Pennsylvania ILECs are doing. Tr. at 385-90. Because Mr. Appleby (erroneously) asserted that the financial position of Verizon's operating companies in Pennsylvania is irrelevant, he did *no* analysis of the financial performance of the Pennsylvania operating companies that are the subject of this proceeding — and he admitted he had *no* reason to question the accuracy of the financial data Verizon has presented. *Id.* at 391. The Sprint witness had not even reviewed the Verizon Pennsylvania Inc. bondholder reports that were relied on and provided with Verizon's Rebuttal Testimony. Tr. at 392. If he had reviewed them, he would have seen that his assumption that "unfortunately, we don't have the full operations of the Verizon Corporation in Pennsylvania in their service territory" (*id.* at 391) was simply wrong. As discussed above, the consolidated reports are on a total company basis and do include interstate (*e.g.*, special access) and unregulated (*e.g.*, FiOS) revenue. He also would have seen that the bondholder reports were audited by Ernst & Young, which found — pursuant to its duty to ensure that investors have accurate information about Verizon Pennsylvania Inc. — that they "present fairly, in all material respects, the consolidated financial position of Verizon Pennsylvania...." See Verizon Rebuttal Ex. C-2 at 2.

(i) is not exorbitant and (ii) provides the LEC with a sufficient opportunity to maintain its financial integrity. *See Public Advocate v. Philadelphia Gas Comm'n*, 544 Pa. 129, 140 (1996). Although Verizon respectfully submits that the framework set forth in the Access Order is erroneous (*e.g.*, it does not agree that a \$2.50 Carrier Charge is reasonable), the Order confirms that Verizon's switched access rates are already well below just and reasonable levels under Pennsylvania law.

Verizon — whose switched rates access have already undergone far more scrutiny than those of the so-called RLECs — *already* charges a composite intrastate switched access rate that is lower than what it would charge under the reasonableness framework set forth in the Access Order.¹⁷ And even if the reasonableness standards set forth in the Access Order standard were applied to Verizon, Verizon would still charge an overall intrastate switched access rate that is one of the lowest in the state.¹⁸ As such, it cannot be considered “exorbitant” from a customer point of view — so the first prong of the just and reasonable standard does not support further rate reductions for Verizon.

The other prong — that the rate structure results in a reasonable opportunity for the firm to recover its costs of regulated services — would clearly not be met by reducing Verizon's switched access rates to levels even lower than what Verizon already charges.

As discussed above, Verizon has presented extensive evidence demonstrating that it is

¹⁷ Verizon currently charges a CC of \$0.58 per month, which is roughly one fifth of the \$2.50 per month level deemed just and reasonable by the Order. Under the Order, Verizon's intrastate usage-based rate elements would be reduced to interstate levels, but the revenue reduction of approximately [BEGIN VERIZON PROPRIETARY] [END VERIZON PROPRIETARY] per month (*see* AT&T St. 1.0 (Nurse/Oyefusi Direct) at 21) associated with that mirroring requirement would be more than offset by the increased CC.

¹⁸ This is one of many factual/policy issues that Verizon would have included in supplemental testimony if it had been given the opportunity to reopen the record. But it is common knowledge that Verizon's interstate rate is the lowest or among the lowest in the state, so under the Order's mirroring requirement Verizon would charge the lowest (or one of the lowest) intrastate rates.

losing money under its existing rate structure — and the Commission must seek to regulate Verizon in a way that affords Verizon a realistic opportunity to recover its costs. Given Verizon’s unique circumstances in Pennsylvania, ordering it to reduce its switched access charges would be a step in the wrong direction.

Attempts to distinguish other access providers from Verizon based on the nature of service territories are misguided. Verizon is very much a rural carrier in Pennsylvania; in fact, it serves more rural lines in the state than all other carriers in the state combined.¹⁹ And at the same time, Verizon faces particularly intense competitive pressure in its urban and suburban territories, contributing to levels of lines losses that exceed those experienced by the “rural” carriers.²⁰ If anything, Verizon’s dual challenges of facing more intense competition than the “RLECs” and maintaining extensive highly costly operations in rural parts of the state, makes it more difficult for Verizon to recover its costs for rate-regulated services than it is for the “RLECs.”²¹

Indeed, an important theme in the “RLEC” access investigation was the “ridiculousness” of proposals that would require *Verizon* — as a purportedly “non-rural” carrier — to subsidize the so-called “rural” ILECs despite any showing that these companies actually used any of the subsidies for universal services purposes. For

¹⁹ See VZ St. 1.0 (Price/Mazziotti Direct) at 44.

²⁰ See VZ. St. 1.0 (Price/Mazziotti Direct) at 17 (“[B]ased on line loss figures previously presented by the RLECs,” it is “reasonable to conclude” that Verizon has been experiencing higher line loss in its “more competitive . . . territory” than the RLECs have experienced).

²¹ As Verizon noted in its petition to reopen the proceeding, this is one of the areas where Verizon intended to supplement the record in light of the Access Order. But regardless of the relative economics of Verizon’s rural versus its non-rural operations, the fact that its overall operations are unprofitable highlights that there is no basis to assume Verizon is distinguishable from other Pennsylvania carriers based on some hypothetical ability to implement a nonrural-to-rural subsidy scheme.

example, the following passage from AT&T's brief was quoted approvingly by Judge Colwell:

1. There are some PTA members whose service areas are more densely populated than Verizon-PA, even after factoring in Philadelphia and Pittsburgh.
2. Ironton Telephone Company has a density of 235.6 household/square mile -- 43 percent more densely populated than Verizon-PA's service area.
3. Denver & Ephrata Telephone & Telegraph Company has a density of 197 household/square mile -- also 20 percent more densely populated than Verizon-PA's service area.
4. North Pittsburgh Telephone Company has a density of 164 household/square mile - essentially equal to Verizon-PA.
5. Verizon's density is 165 household/square mile, which given the enormous density of Pittsburgh in Philadelphia metro areas, means Verizon must serve some substantial quantities of very sparsely populated areas in order to have an average density of 165 household/square mile.

These facts were undisputed. This all points to the ridiculousness of a policy whereby Verizon's customers, including both the urban poor and the rural customers Verizon serves, are subsidizing the PTA companies, who, in some cases, serve more highly or comparably dense areas on average, and whose rates often are lower than what Verizon charges its customers.²²

A related theme in the RLEC Access Investigation was the fact that the RLECs, in stark contrast to Verizon here, did not present any cost or financial data to support their arguments. As Sprint summarized:

As has been extensively discussed in its Main Brief and herein, the RLECs have presented *no cost data whatsoever*. This fact makes all the more

²² See Recommended Decision before Susan D. Colwell, *Investigation Regarding Intrastate Access Charges and IntraLATA Toll Rates of Rural Carriers and the Pennsylvania Universal Service Fund*, Docket No. I-00040105 (issued July 22, 2009), at 52 (citing AT&T Main Brief at 25-26).

puzzling that in the context of discussing the meaning of revenue neutrality under Pennsylvania law, CenturyLink indicates that revenue neutrality “cannot be related to cookie-cutter application” and that “Act 183 cannot be interpreted to result in unfunded or inadequately funded mandates for statutory obligations or Commission policies.” It is unfortunate that CenturyLink and the PTA refused to provide cost data requested of them by other parties, including Sprint. It is inexcusable, however, for the RLECs to argue that the lack of cost information on the record — information they failed to voluntarily place on the record, and repeatedly refused to produce — can somehow form the basis for a determination that any statutory mandate or Commission policy is unfunded.²³

Similarly, AT&T criticized “the RLECs’ complete and sustained failure to present any actual data to support their claims that access reform will hinder their ability to meet obligations.”²⁴

Given that Verizon *has* submitted extensive evidence showing that the combination of competitive pressures and burdensome regulation are causing it to lose money both on the provision of rate-regulated services and on an overall basis, there is no basis to impose a lower switched access rate on Verizon than what has been determined to be just and reasonable for other ILECs.²⁵

²³ *Investigation Regarding Intrastate Access Charges and IntraLATA Toll Rates of Rural Carriers and the Pennsylvania Universal Service Fund*, Docket No. C-2009-2098380, *et al.*, Sprint Reply Brief (filed June 3, 2010) at 41.

²⁴ *Investigation Regarding Intrastate Access Charges and IntraLATA Toll Rates of Rural Carriers and the Pennsylvania Universal Service Fund*, Docket No. C-2009-2098380, *et al.*, AT&T Reply Brief (filed June 3, 2010) at 13.

²⁵ Again, Verizon is disadvantaged by its inability to update the record to provide testimony relating to why there are no differences between Verizon and RLEC that would justify different treatment in terms of application of the Commission’s articulated just and reasonableness framework. But it is common sense that if the evidence shows that Verizon alone is losing money on its rate-regulated services, there are no economies of scale, economies of scope, or any other attributes that would justify disparate treatment.

C. Arguments that these Threshold Considerations Should Be Ignored Are Misguided.

1. The Commission May Not Ignore Verizon's Financial Losses.

AT&T argues that the Commission should divorce this proceeding from consideration of Verizon's financial position. *See, e.g.*, AT&T St. 1.0 (Nurse/Oyefusi Direct) at 37-40. However, it is not permissible for this Commission to impose an unjust and unreasonable rate structure on the Verizon ILECs based on the possibility that some future proceeding might provide them with additional revenue or with relief from regulatory burdens causing financial losses. When presented with evidence a regulated company is experiencing financial distress, the Commission must determine that the rates are just and reasonable at the time it puts them into effect. That is the central holding of *Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168 (D.C. Cir. 1987) (en banc). There the D.C. Circuit held that a regulator could not ignore the regulated company's evidence that the end result of the regulator's decision was to jeopardize its financial integrity. In the face such evidence, the regulator "made no findings, performed no balancing, [and] offered no reasoned consideration of [the utility's] allegations." *Id.* at 1178. Because the regulator "flatly refus[ed] to consider a factor to which it is undeniably required to give some weight [*i.e.*, the confiscatory effect of its rate order], its decision cannot stand." *Id.* at 1182.

Under *Jersey Central*, when a utility presents evidence that it is in financial distress, an agency is "obligated" to consider whether new rates will be compensatory before it implements them. *Mo. Pub. Serv. Comm'n v. FERC*, 337 F.3d 1066, 1074 (D.C. Cir. 2003) ("We agree with the Commission that it was obligated 'to consider the impact the initial rates would have on Kansas Pipeline's financial integrity.'" (*citing, inter alia*,

Jersey Cent., *supra*, 810 F.2d at 1177-78, 1182)); *see also Algonquin LNG, Inc. v. FERC*, 570 F.2d 1043, 1051 (D.C. Cir. 1978) (rate order must be set aside because agency “disregard[ed] . . . whether the imposed rate was confiscatory”).

2. The Commission Is Prohibited from Requiring Verizon to Subsidize Rate-Regulated Services With Earnings from Non-Jurisdictional or Competitive Services.

Sprint appears to suggest that Verizon’s massive losses on rate-regulated services can be “made up” by earnings from other services. *See Appleby Direct* at 26-27. But non-jurisdictional service revenues cannot and should not be included toward regulated cost recovery. As an initial matter, this Commission can only consider revenues from intrastate services within its jurisdiction. *See Smith v. Ill. Bell. Tel. Co.*, 282 U.S. 133, 149 (1930). Accordingly, it cannot consider revenues that are assigned to the interstate jurisdiction or other services not within this Commission’s jurisdiction.

Likewise, the Commission cannot consider revenues from unregulated or competitive services. Both black letter law and sound policy mandate that an ILEC may not be required to operate the segment of its business that remains subject to the regulator’s control at a loss on the theory that profits from competitive lines of business will make up the shortfall. As Justice Holmes explained in *Brooks-Scanlon Co. v. Railroad Comm’n*, 251 U.S. 396, 399 (1920), the profits that an enterprise earns in competitive operations are private property, and the firm “no more can be compelled to spend that than it can be compelled to spend any other money to maintain [the enterprise] for the benefit of others who do not care to pay for it.”

As the New York Public Service Commission explained in rejecting a similar argument:

Some parties suggest that Verizon's wireline competitive losses in New York should only be considered in the context of profits made in other competitive lines of business and regulated profits made in other states by Verizon New York Inc.'s parent company. This would be a significant departure from the traditional approach of reviewing jurisdictional costs and associated revenues. See *Brooks-Scanlon Co. v. Railroad Comm'n*, 251 U.S. 396 (1920) and *City of New York v. United States*, 337 F. Supp. 150 (E.D.N.Y. 1972). Investors do not typically continue to support one project simply because another unrelated project is profitable. We decline to rely on non-jurisdictional earnings to offset jurisdictional losses.²⁶

Moreover, as a practical economic reality, in a competitive market Verizon cannot be expected to maintain the prices of its non-regulated services at levels that generate consistent and adequate contribution levels for rate-regulated services. Market forces, of course, discipline the prices Verizon can charge and the margins it can obtain.

In any event, even aside from the fact that it would be patently unlawful for the Commission to consider earnings from non-jurisdictional or competitive services, any margins from those services are insufficient to subsidize Verizon's money-losing operations on rate-regulated services. As discussed above, both the annual reports filed with this Commission and the bondholder reports prepared for investors show that on a *total company basis* the principal Verizon ILEC, Verizon Pennsylvania Inc., is sustaining substantial losses. Given that those financial reports include *all* revenue and *all* expenses associated with the operating company's operations, including FiOS video and broadband services,²⁷ there are no margins from any other services even theoretically available to

²⁶ See Statement of Policy on Further Steps Toward Competition in the Intermodal Telecommunications Market and Order Allowing Rate Filings, *Proceeding on Motion of the Commission to Examine Issues Related to the Transition to Intermodal Competition in the Provision of Telecommunications Service*, Case 05-C-0613 (N.Y. Pub. Serv. Comm'n issued Apr. 11, 2006), at 55 n.112.

²⁷ See Tr. at 121-122; see also VZ Rebuttal Ex. C-2, page 7 (stating that unregulated and interstate services, including video, broadband, and special access services, are included in consolidated financial statements of Verizon Pennsylvania Inc); VZ Direct Exhibits C-1 at 3; C-2 (stating that the Annual Report submitted by Verizon Pennsylvania to this Commission is done on a "Total Company" basis).

subsidize Verizon's rate-regulated services. So Sprint's argument is factually as well as legally flawed.

III. The Commission Cannot Unilaterally Further Reduce Verizon's Access Charges in the Face of the Burdensome Asymmetrical Regulation that Is Precluding Verizon from Recovering Its Costs.

Nearly a century ago the Superior Court of Pennsylvania succinctly stated an economic truism that is at the heart of regulation: "Unrestricted competition and regulation are inconsistent." *Relief Elec. Light, Heat & Power Company's Petition*, 63 Pa. Super. 1 (Pa. Super Ct. 1916). In that case, the court upheld a Commission decision to protect the financial integrity of an electric utility by excluding a competitor from operating in its territory. *Id.* Today, of course, the notion that the Commission might protect incumbent telephone companies like the Verizon ILECs from competition is anathema to contemporary communications policy. In fact, state and federal policies expressly aimed at *promoting* entry into Verizon's service territory have helped usher in an era of vigorous competition. Such "unrestricted competition," combined with burdensome asymmetrical legacy regulation, has led to the financial deterioration of the Verizon ILECs — which have lost almost *half* of their access lines and are sustaining substantial losses on the provision of rate-regulated services.

A. The Verizon ILECs Are Under Intense Competitive Pressure and their Customer Base Is Disappearing at a Remarkable Rate.

As AT&T recently told the FCC, "[t]he legacy POTS business model is declining at an astonishing rate. Incumbent carriers are hemorrhaging customers to competitors as consumers increasingly abandon legacy wireline services for wireless, VoIP, and other

services.²⁸ This is no more true than for Verizon in Pennsylvania, a fact that no party has disputed. Over the past decade the Verizon ILECs have lost nearly half of their access lines, while the number of lines served by competitors has increased dramatically.²⁹ Despite population and economic growth in the state,³⁰ Verizon's access lines have steadily declined, demonstrating that it faces continuing competition for traditional voice services.³¹ This trend of diminishing access line counts is apparent throughout Verizon's service territory, in urban, suburban and rural areas.³²

FCC data confirms this trend of ILEC line loss. As compared to the 8 million access lines served by Pennsylvania ILECs (the RLECs and Verizon combined) at the end of 2000,³³ ILEC lines had declined to just 4.6 million as of June 30, 2010.³⁴ At this rate of

²⁸ *In the Matter of Connect America Fund A National Broadband Plan for Our Future*, FCC WC Docket No. 10-90, Comments of AT&T filed April 18, 2011 at 54.

²⁹ From 2000 through September 2010, the Verizon ILECs experienced line loss of [BEGIN PROPRIETARY] [END PROPRIETARY]. VZ St. 1.0 (Price/Mazziotti Direct) at 15.

³⁰ Pennsylvania population grew 2.6% between April 1, 2000 and July 1, 2009 and private nonfarm employment grew 2.1% from 2000-2007. <http://quickfacts.census.gov/qfd/states/42000.html>. VZ St. 1.0 (Price/Mazziotti Direct) at 15.

³¹ The volume of telephone numbers ported from Verizon to its facilities-based competitors is another indicator of competitive loss. Verizon's local number portability ("LNP") data demonstrate that more than [BEGIN VERIZON PROPRIETARY] [END VERIZON PROPRIETARY] numbers had been ported completely off Verizon's Pennsylvania network as of December 2010, with an average of more than [BEGIN VERIZON PROPRIETARY] [END VERIZON PROPRIETARY] numbers being ported off Verizon's Pennsylvania network each month during 2010. VZ St. 1.0 (Price/Mazziotti Direct) at 18.

³² Over the period from December 2006 through September 2010, Verizon's line losses in Density Cells 1 and 2 (locations in the cities of Philadelphia and Pittsburgh) have been [BEGIN VERIZON PROPRIETARY] [END VERIZON PROPRIETARY], respectively. Over that same period, Verizon's line loss in suburban Density Cell 3 has been [BEGIN VERIZON PROPRIETARY] [END VERIZON PROPRIETARY] and its line loss in rural Density Cell 4 has been [BEGIN VERIZON PROPRIETARY] [END VERIZON PROPRIETARY]. The Density Cell 3 and 4 figures are combined Verizon PA and Verizon North. Verizon North does not have operations in Density Cells 1 and 2. VZ St. 1.0 (Price/Mazziotti Direct) at 16.

³³ FCC, Industry Analysis & Technical Division, Wireline Competition Bureau, *Local Telephone Competition Status as of December 31, 2000*, Table 6, available on-line at: http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/lcom0501.pdf (VZ Direct Exhibit A-1 to VZ St. 1.0).

³⁴ FCC, Industry Analysis & Technical Division, Wireline Competition Bureau, *Local Telephone Competition Status as of June 30, 2010*, available on-line at:

erosion, Pennsylvania ILECs will, as of the end of this 2011, serve about half of the lines they had in 2000. The FCC's report also shows that as of June 30, 2010, "non-ILECs" (a term that includes CLECs and VoIP providers, but not wireless providers) served 34% of the wireline switched access lines in the state.³⁵ Among other things, the FCC observed that "interconnected VoIP service subscribership has continued to increase while subscribership to traditional wired telephone services has declined."³⁶ The report reflects the fact that telephone service is available from wireline companies other than ILECs in virtually all Pennsylvania zip codes. As of June 30, 2010, more than half of Pennsylvania zip codes had ten or more non-ILEC wireline providers (52%) and only 2% of zip codes lacked competition from any non-ILEC wireline provider — again, without counting wireless competition.³⁷

Wireless subscribership statistics tell an even more compelling competition story. The FCC reports 11.1 million wireless subscribers in Pennsylvania as of June 30, 2010 — well over twice the number of ILEC lines, and up from 10.9 million 6 months earlier.³⁸ This figure is consistent with nationwide trends; wireless penetration in the United States reached 93% as of year end 2009.³⁹ Indeed, by December 2010, roughly 30 percent of all American

http://www.fcc.gov/Daily_Releases/Daily_Business/2011/db0321/DOC-305297A1.pdf, Table 8 (VZ-Rebuttal Exhibit A to VZ St. 1.1).

³⁵ *Id.*

³⁶ FCC Local Competition Report as of 6/30/2010, at 1.

³⁷ Local Telephone Competition Report as of June 30, 2010, Table 20 (VZ-Rebuttal Exhibit A to VZ St. 1.1).

³⁸ Local Telephone Competition Report as of June 30, 2010, Table 17 (VZ-Rebuttal Exhibit A to VZ St. 1.1).

³⁹ *FCC Annual Report and Analysis of Competitive Market Conditions With Respect to Mobile Wireless, Including Commercial Mobile Services*, Fifteenth Report, ¶ 393, available on-line at <http://wireless.fcc.gov/index.htm?job=reports>. This publicly available data has been updated since Verizon submitted its testimony (see VZ-Direct Exhibit A-3 to VZ St. 1.0, showing wireless penetration at 90% as of year-end 2008.).

households (29.7%) had only wireless (not landline) telephone service (and another 15.7% took all or nearly all calls on wireless phones), and that cord-cutting trend shows no sign of being reversed.⁴⁰

According to the FCC's most recent report on telephone subscribership in the United States, despite the dramatic Verizon line losses, telephone subscribership in Pennsylvania is at an all-time high,⁴¹ demonstrating that Pennsylvania consumers have plenty of other options for voice service.

Verizon's substantial and worsening financial losses (discussed above) are hardly surprising for a company that continues to be heavily regulated under a regime developed for a monopoly industry, even though the company is subject to intense, ubiquitous competition.⁴² As AT&T recently explained to the FCC: "incumbents are losing lines with astonishing speed Yet, due to the high fixed costs of providing POTS service, the costs that incumbents incur to maintain their facilities are declining far more slowly, and thus every customer that abandons an incumbent raises the average cost per line of serving those customers that remain."⁴³ In fact, according to AT&T, "[w]ith an outdated product, falling

⁴⁰ Centers for Disease Control, *Wireless Substitution: Early Release of Estimates from the National Health Interview Survey, July-December 2010* (rel. June 8, 2011) at 1, available on-line at: <http://www.cdc.gov/nchs/data/nhis/earlyrelease/wireless201106.htm>. This publicly available data has been updated since Verizon submitted its testimony. See VZ-Direct Exhibit A-4 to VZ St. 1.0 (showing that at mid-year 2010, 26.6% of all American households had only wireless service and another 15.9% took all or nearly all calls on wireless phones); Morgan Stanley Research, *Telecom Services Wireless Substitution Reaches 26.6% in 1H10, Doubles Fixed-Line Only*, January 30, 2011 (estimating that as of year-end 2010, 29% of households were wireless-only, and that this percentage will continue to grow).

⁴¹ FCC, Industry Analysis & Technical Division, Wireline Competition Bureau, *Telephone Subscribership in the United States*, Data through March 2010, available on-line at: http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-301241A1.pdf (VZ-Direct Exhibit A-6 to VZ St. 1.0).

⁴² See VZ-Rebuttal Exhibit B to VZ St 1.1 (a chart showing key entries from the Verizon ILECs' annual reports over the years).

⁴³ *In the Matter of Connect America Fund A National Broadband Plan for Our Future*, FCC WC Docket No. 10-90, Comments of AT&T (filed April 18, 2011) at 11.

revenues, and rising costs, incumbent wireline telephone companies face a ‘death spiral’ that makes their POTS business model increasingly unsustainable.” (*Id.* at 12). Verizon is confronting just such a situation in Pennsylvania.

As Verizon’s witnesses explained, the decline in operating revenue is attributable to the effects of retail competition and line loss on Verizon’s retail revenues and declines in access volumes, combined with regulation that, among other things, severely restricts Verizon’s flexibility to compete in the market, significantly increases Verizon’s costs compared to its largely unregulated competitors, and continues to require Verizon to provide below-cost service to some of its customers. But the Verizon ILECs’ expenses have not experienced a similar decline, because while access line losses may allow Verizon to reduce its variable costs, Verizon’s fixed costs — as well as costs caused by asymmetrical regulation that applies uniquely or disproportionately to Verizon — do not decline at the same pace. The result is that such fixed costs are spread across a smaller base of lines. These downward trends can be expected to continue, particularly with the Verizon ILECs unable to operate their business like their competitors — free of the constraints of outdated monopoly-era regulation.⁴⁴

B. Burdensome Monopoly-Era Regulation Precludes Verizon from Recovering Its Costs.

Before the Commission considers reducing Verizon’s access charges further than it already has, legacy regulatory burdens that increase Verizon’s costs and impede its ability to compete must be removed. As AT&T recently told the FCC, “[l]egacy service obligations are not merely unfair to providers; they are affirmatively harmful to consumers” and have “no countervailing benefit” because “[l]egacy service obligations

⁴⁴ VZ St. 1.0 (Price/Mazziotti Direct) at 22.

are no longer necessary to ensure that customers have ready access to voice communications services.”⁴⁵

The record supports relieving Verizon from asymmetric regulatory burdens. These regulations may have been appropriate in an era that has gone the way of the typewriter and the rotary phone, but they do not best serve the public interest *today*. In today’s competitive environment, companies are best able to meet customer expectations when they are free from excessive and unneeded regulation. (Verizon St. 1.0 at 36-37). Continuing to regulate the Verizon ILECs as if they were “monopoly” providers with virtually guaranteed revenue streams and no competition — when none of those things is true — will only hasten the demise of Verizon’s wireline business predicted by AT&T, ultimately hurting consumers and diminishing competitive options. Reducing Verizon’s access charges without also eliminating these anachronistic regulations would simply create the worst of both worlds.

Outdated regulatory obligations permeate virtually every business function in which the Verizon ILECs engage, creating market distortions and substantially constraining Verizon’s ability to efficiently produce services and market them effectively to customers. As unregulated and lightly regulated competitors continue to gain market share, it is imperative that Verizon be put on equal footing with its competitors to alleviate the anti-competitive and anti-consumer effects of these disproportionate burdens. The legacy regulations that burden Verizon and its customers include:

Constraints on Discontinuing Service Offerings — Under the existing regulatory paradigm in Pennsylvania, Verizon must obtain Commission approval to discontinue an

⁴⁵ *In the Matter of Connect America Fund A National Broadband Plan for Our Future*, FCC WC Docket No. 10-90, Comments of AT&T (filed April 18, 2011) at 59.

outdated service that customers no longer demand, and for which competitive alternatives exist.⁴⁶ In considering any such potential discontinuance, the Commission considers a series of factors that are relevant only in the context of traditional utility regulation. For example, one such factor is whether “the utility’s losses could be cured by the granting of a reasonable rate increase.”⁴⁷ In the competitive communications marketplace, however, the Commission is not able to simply “grant” a reasonable rate increase; it is customers who decide whether a service is worth subscribing to at any given price. Yet Verizon is forced to operate in a competitive marketplace without the flexibility necessary to compete, including the flexibility to discontinue outdated services no longer sought by customers. These rules apply only to wireline carriers that are defined by statute to be “public utilities” under 66 Pa. C.S. § 102. They do not, and cannot, apply to cable VoIP providers, nomadic VoIP providers or wireless carriers (nor should they).

Regulation of Verizon’s Services and Interaction with its Customers — As detailed in Verizon’s testimony, numerous Commission regulations constrain Verizon’s interaction with its customers with respect to service and billing.⁴⁸ These requirements for

⁴⁶ 66 Pa. C.S. § 1102(a)(2).

⁴⁷ See *Application of Hillside Estates Water System*, 1997 Pa. PUC LEXIS 23 (Pa. Pub. Util. Comm’n 1997) at *10 (citing *Re Megargel’s Golf, Inc.*, 59 Pa.P.U.C. 517, 522 (1985)).

⁴⁸ VZ St. 1.0 (Price/Mazziotti Direct) at 34-48. Among other things, these rules: dictate how Verizon is permitted to bill its customers (52 Pa Code § 64.11, etc.); limit Verizon’s ability to deal with non-paying customers (52 Pa Code § 64.31, etc., 64.51, etc., 64.61, etc., 64.121, etc.); dictate the information Verizon must provide to its customers (e.g., 52 Pa Code § 64.191, etc.); impose requirements for installation, service and repair for Verizon’s customers (52 Pa Code § 63.51, etc.); and impose a costly process whereby the Commission administers formal and informal complaints from Verizon customers (e.g., 52 Pa Code § 64.131, etc.). There are rules restricting call recording, which even the Commission recognizes is a ubiquitous practice for competitors and other industries. Verizon must file a number of reports with this Commission that its competitors do not — including annual financial reports, lifeline tracking reports, service outage reports, annual Chapter 64 service reports, and surveillance level reports. Verizon is also required to file notice of certain affiliate agreements. And following the filing of reports, Verizon is often forced to devote resources to answering follow-up requests from Commission staff. Verizon is subject to tariff filing requirements, and has even faced Commission resistance to de-tariffing competitive services despite statutory

the most part were adopted decades ago, when the individual ILECs were the sole providers of telephone service in their franchise territories and operated under rate-of-return regulation. These requirements are not only unnecessary in today's competitive market but are affirmatively harmful because they require regulation, not consumer preferences, to drive business decisions. Companies today need to have the freedom to target their services to providing what customers want and need, rather than to meeting decades-old regulatory standards that may have no bearing on the real-world desires of customers. Filing and litigating waiver petitions to ease individual rules — with the attendant costs, uncertainty, and delay — is no answer when competitors are free to make immediate changes to their own practices and operations to meet customer demands (and then to subsequently modify them as necessary as the market evolves).⁴⁹

The vigorously competitive telecommunications market provides the best incentives for carriers to interact with their customers in optimal ways. What a particular customer perceives as optimal service depends on individual preferences, and imposing prescriptive standards is inconsistent with satisfying those varied (and changing) preferences. The Commission should not assume, for example, that a particular level of quality is necessarily the optimal level since there are typically tradeoffs between service quality and the prices that consumers are willing to pay. The optimal quality level for a particular individual is that which provides the highest perceived value relative to the price of the service, not a particular level a regulator may arbitrarily deem “best” for consumers. Verizon's

authorization. Verizon must secure Commission approval for a wide range of corporate transactions, from company-changing mergers all the way down to minor corporate restructurings and certain asset transfers. Regulated telephone companies are forced to incur huge litigation costs and delays that may threaten closing of the transaction, or to settle with the demanding parties in order to secure Commission approval. Verizon's unregulated competitors are free to structure and re-structure their businesses in the most efficient way, as the market and consumer demands evolve.

⁴⁹ See VZ St. 1.0 (Price/Mazziotti Direct) at 36.

competitors, which are not hobbled by excessive regulation of their customer interactions to the extent that Verizon is, are able to react nimbly to meet the customers' expectations, while Verizon is not. A well-documented example of competition driving optimal service is in the mobile wireless industry, where the result has been dramatically lowered prices and increased service quality in the absence of regulation.⁵⁰

In short, in an intensely competitive telecommunications market, where every advantage counts, Verizon's unregulated competitors have the significant advantage of not having to deal with anachronistic regulations and unwieldy regulatory process.

Constraints on Retail Pricing Flexibility - Verizon also faces regulatory constraints on its pricing flexibility that do not apply to its competitors. Although Verizon may flexibly price services classified by the Commission as "competitive," its prices are essentially capped for services classified as "non-competitive" — despite the fact that so-called "non-competitive" services like residential and single-line business services are indisputably subject to intense and ever-growing competition. As demonstrated by the margin analysis discussed in the next section, those price caps result in below-cost rates for stand-alone retail service to residential and small business customers. The Commission has the authority to reclassify Verizon's remaining retail services as competitive to provide the pricing flexibility that is necessary and appropriate in today's competitive market, and the Commission should do so immediately.⁵¹

State Universal Service Fund and Access Charges Paid to Other Rural

⁵⁰ *Id.* at 37.

⁵¹ Verizon has discovered recently, however, the limits of relief associated with competitive classification as the Commission did not recognize Verizon's lawful withdrawal of its tariffs for competitive services.

Carriers - Each year Verizon is required to contribute a significant amount of intrastate revenue to the state universal service fund. Those payments — like the hundreds of millions Verizon pays into the federal USF funds, which similarly subsidize other carriers — is money Verizon could otherwise utilize for continued investment and innovation to benefit customers. For 2011, the contribution assessment of Verizon PA and Verizon North is *\$16.3 million*.⁵² All of the money from this fund is provided to companies that have no requirement to use it for any pro-universal service purpose. Verizon receives nothing from the state USF fund but is required to contribute to other RLECs with this annual payment despite the facts that Verizon has experienced greater line losses than those other companies *and that it serves more rural customers than all of the “RLECs” combined*.⁵³ While the Commission’s Access Order directs the opening of a rulemaking to investigate the structure and continued need for this fund, the current obligations are likely to remain in place until that matter is litigated. Moreover, as discussed above, the millions of Verizon’s customers in Pennsylvania are also worse off because of the millions of dollars in contributions to the federal USF that get shipped around the state and around the country. Overall, Pennsylvania consumers contributed approximately \$333 million to the federal fund last year, and only about \$185 million was returned to Pennsylvania consumers, schools and libraries, rural hospitals, and carriers.⁵⁴

⁵² The total 2011 assessment for all Verizon affiliates taken together is \$18.2 million. Pursuant to the Commission’s order at docket No. P-00930715 entered October 11, 2005, Verizon PA may request permission each year to use the on-going value of its banked negative 2003 PCO to support its payments to the USF. Under this arrangement, Verizon PA pays cash to the USF each year, but is permitted to account for that payment against the banked negative value of the 2003 PCO instead of implementing that negative PCO in a manner directed to benefit its own customers. This arrangement does not apply to the USF contributions of Verizon North or other Verizon affiliates.

⁵³ See VZ St. 1.0 (Price/Mazziotti Direct) at 43-44.

⁵⁴ See Bipartisan Energy and Commerce Leaders Release Information on Universal Service Fund, Press Release (July 27, 2011) at Request 1 (FCC Response to Universal Service Fund Data Request, State-

In addition to direct subsidies to the RLECs, Verizon continues to pay unreasonably high RLEC access charges. The Verizon ILECs alone paid [BEGIN VERIZON PROPRIETARY] [END VERIZON PROPRIETARY] in RLEC access charges in 2010, without considering the additional millions paid by their affiliates. These charges are based on RLEC rates that average 5 cents a minute, and range up to 10 cents per minute. The Commission in its Access Order determined that these excessive access rates are not just and reasonable, but it will take four years to reduce them and even then the end result will be RLEC access rates that remain higher than Verizon's current rates. And, of course, Verizon customers also continue to pay high access rates to other carriers nationwide and make "net" contributions to the federal USF, shipping subsidies to carriers around the country rather than keeping those dollars in Pennsylvania.

Broadband Deployment and BFRRs — As an alternatively regulated carrier under Chapter 30 of the Public Utility Code, Verizon is obligated to provide 100% broadband availability by December 31, 2015 and must provide a "bona fide retail request" or "BFRR" program deploying broadband earlier where the required number of qualifying requests are received from local residents. As long as these requirements exist, the Commission must account for the fact that Verizon faces these huge and uneconomic burdens when it makes other decisions with regard to its regulation of Verizon — including regulation of its switched access charges. These obligations require

by-State USF Support, Estimated Contributions and Estimated Net Dollar Flows and State-by-State Top 10 Recipients), page 1,
<http://democrats.energycommerce.house.gov/index.php?q=news/bipartisan-energy-and-commerce-leaders-release-information-on-universal-service-fund>.

huge investments.⁵⁵ The Verizon ILECs have met these stringent requirements despite the sharp line losses they have experienced and despite their ever-darkening financial picture. The statute does not obligate customers to purchase broadband service from Verizon. Broadband service is available from a wide variety of competitors in Pennsylvania, just like voice service, and the evidence shows that customers are purchasing a significant portion of their broadband service from competitors.⁵⁶ Much of Verizon's broadband deployment to meet its obligation has been uneconomic.⁵⁷ It has been undertaken because of regulatory requirements, despite the fact that there was not always a "business case" for the deployment. Verizon's unregulated competitors, on the other hand, are free to follow business plans based solely on the potential for profit.

⁵⁵ This aggressive broadband deployment has been made possible by a capital investment program that has exceeded \$13 billion since the start of Verizon PA's network modernization obligations under the old Chapter 30 statute in 1994, through 2010. In the past six years — from 2005 through 2010 — Verizon has made capital investments of over \$2.5 billion in the broadband network. In 2010 alone, Verizon invested [BEGIN VERIZON PROPRIETARY] [END VERIZON PROPRIETARY] in capital deploying facilities to satisfy BFRRs. See VZ St. 1.0 (Price/Mazziotti Direct) at 45.

⁵⁶ The FCC reports that as of year-end 2008 in Pennsylvania there were 1.2 million DSL high-speed connections, 1.8 million cable modem high-speed connections and nearly 900,000 mobile wireless high-speed connections. Industry Analysis and Technology Division Wireline Competition Bureau, *High-Speed Services for Internet Access: Status as of December 31, 2008*, Table 14, available on-line at: http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-296239A1.pdf (VZ-Direct Exhibit A-5). The FCC defines "high speed" for this report as at over 200 kbps in at least one direction. The number of cable modem connections nearly doubled in the three and a half years between June of 2005 and December 2008. According to the FCC, 98% of Pennsylvania residential customers who have cable TV service available to them also have access to high-speed service via cable modem. (*Id.*, Table 19).

⁵⁷ With regard to Verizon's High Speed Internet ("HSI" — formerly known as "DSL") service, in general only about [BEGIN VERIZON PROPRIETARY] [END VERIZON PROPRIETARY] of Verizon PA's customers and [BEGIN VERIZON PROPRIETARY] [END VERIZON PROPRIETARY] of Verizon North's customers who have the service available to them actually purchase it. Although the take rate is slightly better in areas where Verizon has built out facilities in response to a BFRR, even those take rates are less than [BEGIN VERIZON PROPRIETARY] [END VERIZON PROPRIETARY]. [END VERIZON PROPRIETARY] Verizon's testimony provides some stark examples of how uneconomic these broadband deployment obligations can be, through the BFRR program. See VZ St. 1.0 (Price/Mazziotti Direct) at 47-48.

Regulatory Assessments - Under 66 Pa. C.S. §§ 510 and 511, Verizon is considered to be a regulated “public utility” that must pay a percentage of its gross intrastate operating revenues as an “assessment” for the purpose of defraying the Commission’s expenses of regulating public utilities. Verizon is also assessed to pay for some of the costs of the Office of Consumer Advocate (71 P.S. § 309-4.1) and the Office of Small Business Advocate (73 P.S. § 399.46). In other words, not only is Verizon regulated to a disproportionate degree as compared to its competitors, but it must pay for this excessive regulation, a cost not faced by its competitors. For the period July 1, 2010 through June 30, 2011 the Verizon ILECs paid \$4.3 million in Commission assessments. This assessment should be reduced along with the level of regulation for Verizon.

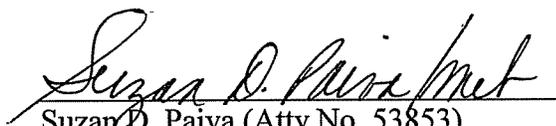
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Fundamentally, the Commission must come to grips with the harms caused by continuing to impose asymmetrical legacy regulation that has no place in a modern communications industry, imposes massive unnecessary costs and Verizon, and artificially constrains Verizon’s ability to compete with unregulated competitors. The Commission should work with Verizon, and with the legislature as appropriate, to forge a new regulatory framework under which Verizon can efficiently deploy and market robust and innovative services to meet competitive pressures. The Commission should do that regardless of the outcome of access reform here and at the federal level, but based on the unique facts presented here it must particularly ensure that any order in this proceeding does not further push Verizon into an unviable financial situation — an outcome that would harm all stakeholders.

The legacy regulatory framework must be replaced with a rational one that includes lower switched access rates for *all* carriers, both within Pennsylvania and nationwide, and the elimination of legacy regulatory burdens and constraints. But this Commission cannot force reductions to rates outside of Pennsylvania — only the FCC can do that — and so unilateral reductions to Verizon’s rates would only force Pennsylvania consumers to ship more money to other states. That problem is compounded by the fact that Verizon is already operating at a substantial loss in Pennsylvania. In this situation the better approach is for the FCC to address reform nationally to avoid the harm to Pennsylvania customers that will result if this Commission were to act in isolation in this case, under the unique facts here.

CONCLUSION

For the reasons set forth above, given Verizon’s unique circumstances in Pennsylvania, including the extensive financial and economic evidence presented, the Commission may not reduce the intrastate switched access rates of the Verizon ILECs in Pennsylvania in isolation while the access rates of other rural carriers will not even be brought down to Verizon’s levels at the end of a four-year implementation period established under the Access Order. Such a result would harm all Pennsylvania and would require Verizon’s customers to continue to ship large subsidy payments to other carriers around the state and across the country through high access charges payments and “net” contributions to the state and federal universal service funds.

A handwritten signature in cursive script, reading "Suzan D. Paiva met", written over a horizontal line.

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