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September 12, 2011

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

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

Very truly yours,

Suzan D. Paiva

SDP/slb

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 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 12th day of September, 2011.

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

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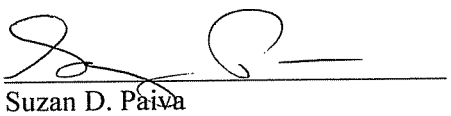

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

REPLY BRIEF OF VERIZON

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Dated: September 12, 2011

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INTRODUCTION

AT&T in its advocacy elsewhere agrees with Verizon that uniformity and symmetry are crucial components of responsible access reform, but here it joins Sprint in urging the Commission to single out Verizon for further unilateral switched access rate reductions. In their single-minded pursuit of lower access rates, these parties ignore this Commission's recent guidance on Pennsylvania access pricing policy and simply declare irrelevant the substantial record evidence that undercuts their arguments. The briefs submitted by AT&T and Sprint both miss the threshold point: Verizon's *current* access rates are already well below what the Commission has deemed just and reasonable under Pennsylvania law and are below what the so-called "rural" Pennsylvania ILECs will charge even after their rates are reduced – and neither Sprint nor AT&T offers any rational basis for disparate treatment of Verizon. The so-called "rural" ILECs are not more rural than Verizon. Quite the contrary, Verizon serves more rural customers and more rural geography than any other provider in Pennsylvania. And (unlike Verizon) none of the RLECs has presented any evidence of financial distress. Yet Verizon and its customers are required to transfer tens of millions of dollars a year to these other companies through universal service fund payments and excessive access rates, even though the RLECs failed to present any evidence that they need such subsidies.

Those and other asymmetrical regulatory burdens imposed uniquely on Verizon impede Verizon's ability to compete effectively in Pennsylvania and to recover its costs for providing services regulated by this Commission. As a result, Verizon sustains substantial losses on rate-regulated services, and is experiencing an unsustainable downward spiral in both access line counts and its financial position. Disparate treatment of Verizon with respect to intrastate access rates is not only arbitrary and contrary to fundamental principles of equal protection and due

process, but it would be harmful to Pennsylvania consumers. Switched access rate differentials create pricing distortions, arbitrage opportunities, and uneconomic subsidy flows which harm consumers – in this case Verizon's retail customers, including its urban and rural and low-income customers, who are required to fund subsidy payments destined for other carriers in other parts of the state and in other states across the country, all without a countervailing mechanism to recover such costs.

Instead of moving forward at the urging of AT&T and Sprint to reduce Verizon's intrastate switched access rates even deeper below the level this Commission has deemed just and reasonable for other ILECs, this Commission should pursue an intrastate access policy that *reduces* pricing distortions by focusing on the state's most excessive switched access charges and moving all carriers toward a more uniform rate. This Commission's order in the rural incumbent local exchange carrier access investigation on July 18, 2011 ("Access Order") constitutes a small step in that direction that is consistent with the expected federal framework, but even at the end of the Access Order's four-year phase-in period the "RLECs" will still charge switched access rates much higher than Verizon's current rate.[1] The record here shows that there is no reason for the Commission to press forward with additional Verizon access reductions given Verizon's unique circumstances in Pennsylvania, the persistence of large harmful differentials among carriers' access rates, the substantial momentum at the FCC favoring comprehensive federal action this fall, and the fact that reconsideration of the seminal Access Order is underway.

Moreover, before considering any further reductions in Verizon's switched access rates, the Commission must address the unique regulatory constraints and burdens that – combined

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[1] *Investigation Regarding Intrastate Access Charges and IntraLATA Toll Rates of Rural Carriers and the Pennsylvania Universal Service Fund*, Docket No. I-00040105 (Opinion and Order entered July 18, 2011).

with intense competitive pressure – are causing Verizon's substantial losses. Sprint and AT&T failed to seriously engage the extensive economic evidence Verizon has submitted on those issues. Their principal argument is that Verizon's evidence of financial losses and asymmetrical burdens should be ignored because it is purportedly irrelevant. But their self-serving assertion is simply wrong. Under these unique circumstances, there is no serious dispute that the kind of unilateral and disparate reductions urged by AT&T and Sprint would have a detrimental effect by undermining continuing investment in Pennsylvania and thereby harming consumers. In addition, alternative regulation has not removed this Commission's responsibility to ensure that the rates for the services it regulates are just and reasonable. It is black letter constitutional law that when establishing rates, this Commission is required to take into account evidence of financial distress. And it must ensure *at the time* it engages in ratemaking that the resulting rates are sufficient to ensure Verizon a *realistic* opportunity to recover its costs for providing the regulated services – not an illusory opportunity as Sprint and AT&T propose.

DISCUSSION

I. The Commission Should Not Proceed Here To Make Access Rate Disparities Worse Without Considering Other Pending Access Reform Efforts.

A. Proposed Access Charge Reductions for Verizon Would Exacerbate Existing Disparities.

The briefs submitted by other parties do not seriously dispute that Pennsylvania's existing disparate access regime creates harmful economic distortions and inequities. Providers lose money when delivering intrastate toll calls to the service territories of the "RLECs" because Verizon's relatively low switched access rate pulls down state-wide long distance prices to levels

below what RLECs charge for switched access. *See* Tr. at 424.[2] Lamenting the "inequities" of such pricing distortions, AT&T's witness noted that bad access policies can create "bad outcomes," such as "maybe AT&T shouldn't provide toll services in the independent telephone company area if the access rates are so high that it causes us to do [sic] a loss." *Id.* The existing regime under which Verizon's customers are required to fund massive subsidy payments to other carriers creates substantial inequities. *See* Verizon Main Br. at 30-32. In the context of the state USF fund, for example, AT&T has acknowledged the "ridiculousness" of a policy "whereby Verizon's customers, including both the urban poor and the rural customers Verizon serves, are subsidizing the [RLECs]."[3]

Given the anti-consumer and anti-competitive harm of widely varying access rates, AT&T *normally* supports symmetrical access reform policies. *See* VZ St. 1.1 (Price/Mazziotti Rebuttal) at 43-44. Here, however, AT&T joins Sprint in insisting that this case must be divorced from any external considerations, including from the principles set forth in the Access Order and in the FCC's pending determination regarding intercarrier compensation reform. *See* Sprint Brief at 4, 18-19; AT&T Brief at 27-29, 31-32. This Commission should reject that simplistic and misguided approach. The Commission must first address the most pressing access distortions in the state (the remarkably high RLEC access rates) before it considers reductions to the statewide rate, but in issuing the Access Order the Commission took only a modest step

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2 *See also* AT&T Surrebuttal Ex. D, page 16 of 20. As discussed below, the pricing distortions caused by disparate switched access rates not only directly harm Verizon and its customers, but they also create harmful arbitrage opportunities, such as incentives for carriers with higher access rates to engage "call pumping" schemes. AT&T's proposal to exacerbate existing access rate disparities would increase existing arbitrage incentives.

3 *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). AT&T also noted that the RLECs in some cases "serve more highly or comparably dense areas on average" and that many had local retail rates that are lower than Verizon's. *Id.*

toward reforming RLEC access rates. Even after the Access Order's modest access reform is fully implemented four years from now, substantial harmful rate disparities will persist and should not be exacerbated by further unilaterally reducing Verizon's access charges. *See* Verizon Main Br. at 5; Office of Small Business Advocate ("OSBA") Main Br. at 11-12.

This Commission must support, with non-arbitrary findings based on an adequate record, any decision to apply a very different policy to one carrier than what it establishes for every other carrier in the state. Given the need to coordinate access policies across carriers (and ultimately across states), it is crucial that the parties to this proceeding be given an opportunity to submit testimony regarding the application here of the principles set forth in the Access Order. But Verizon's Petition to Reopen the Record was denied, so there are a number of factual and policy issues relevant to this proceeding that cannot be developed in post-hearing briefs. It would be premature for the Commission to go forward to consider further access reductions in the present proceeding given the deficient record in light of the Access Order and the fact that the Commission has granted reconsideration of the Order.

B. Neither Sprint nor AT&T Offers a Rational Basis for Disparate Treatment of Verizon.

Neither AT&T nor Sprint even attempts to present any factual or policy rationale that would justify singling Verizon out for disparate treatment. AT&T, for example, asserts that "whatever purpose" the Commission may believe is served by higher rates for the RLECs is plainly not applicable to Verizon" (AT&T Main Br. at 39). But AT&T does not support that statement with any facts or analysis. Among the economic realities Sprint and AT&T shrug off are:

- Verizon serves more rural lines than all of the so-called "rural" ILECs combined. Indeed, with approximately 1,000,000 rural Pennsylvania customers, Verizon serves far more rural lines and rural geography than any of the individual RLECs.[4] In fact, the next largest "rural" company serves only about 300,000 rural customers.

- Many of the "rural" ILECs serve "more highly or comparably dense areas on average" than Verizon. (Access Order at 65). As this Commission itself has recognized, a number of RLECs, including Ironton, Denver & Ephrata and North Pittsburgh have "service areas [that] are *more* densely populated than Verizon-PA, even after factoring in Philadelphia and Pittsburgh," and that "given the enormous density of Pittsburgh and Philadelphia metro areas," "Verizon must serve some substantial quantities of very sparsely populated areas in order to have an average density" lower than these RLECs. *Id.*

- Verizon alone has shown that it is losing substantial amounts of money on the provision of services regulated by this Commission. Verizon's cost study and margin analysis demonstrate that Verizon is losing **[BEGIN VERIZON PROPRIETARY]** **[END VERIZON PROPRIETARY]** annually on its rate-regulated services. (VZ St. 1.0 at 29). No RLEC has even attempted to make a similar showing.[5]

- Verizon alone has presented financial evidence showing that even on a total-company basis – that is, including Verizon's video and broadband operations – Verizon is losing money in Pennsylvania. Verizon PA's audited Bondholder Report shows a net loss of $122 million in 2010, while its annual financial reports to this Commission similarly show a negative net operating income. (VZ St. 1.1 at 8, 16). No RLEC has even attempted to make a similar showing.

- Verizon is under intense competitive pressure that has caused it to lose **[BEGIN VERIZON PROPRIETARY]** **[END VERIZON PROPRIETARY]** of its access lines. That is a larger percentage than the RLECs have lost. And Verizon faces particularly intense competition in urban markets where its losses are acute.[6]

- Verizon and its customers are already required to ship tens of millions of dollars annually to the RLECs in the form of excessive access charges and USF payments. That reality will continue even after the four-year phase-in period under the Access

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

5 Verizon Main Br. at 17-18.

6 VZ St. 1.0 (Price/Mazziotti Direct) at 15, 17; Verizon Main Br. at 16.

Order is complete because Verizon's existing rate is much lower than the "end game" rates authorized for the RLECs under the Access Order framework.[7]

- There is no requirement that any RLEC demonstrate or certify that it needs or uses any of the access subsidies (or USF subsidies) for universal service purposes, and no RLEC has even attempted to demonstrate that it does.[8]

The *only* party other than Verizon to present any comparative analysis regarding Verizon and the so-called RLECs is the Office of Consumer Advocate ("OCA"). OCA's witness observed during the hearing that "Verizon does serve some very rural exchanges" which "probably don't provide enough money to support themselves." Tr. at 344-45. OCA correctly does not advocate further access reductions for Verizon at this time. But OCA's witness suggested that, unlike the RLECs, Verizon has an "internal universal service fund within Verizon where its urban and suburban customers pay enough money to cover its rural customers." Tr. at 345. Dr. Loube did not however provide any evidence to support the existence of such an "internal universal service fund" – presumably because OCA, unlike AT&T and Sprint, does not contend that any differences between Verizon and the RLECs should require Verizon to unilaterally reduce its switched access rates.[9] If such an internal transfer mechanism ever existed, today there is no basis to conclude that urban and suburban customers are capable of subsidizing below-cost rural basic exchange rates given the dramatic line loss and competitive inroads in urban and suburban areas. Indeed, the record of Verizon's financial deterioration and its negative margin disproves the OCA's speculation regarding any "internal universal service fund."

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7 *Id.* at 43-44; Verizon Main Br. at 5; *see also* OSBA Main Br. at 11-12.

8 VZ St. 1.0 (Price/Mazziotti Direct) at 43-44; Verizon Main Br. at 17-18.

9 To the contrary, in countering Sprint's suggestion that Verizon should be required to further reduce its switched access rates, Dr. Loube observed that that Verizon, unlike the RLECs, does not receive any state universal service fund money. Tr. at 344.

In fact, the notion of an urban-to-rural subsidy flow is completely backwards given the contemporary reality that Verizon's acute losses in urban markets render it even less capable than the so-called "rural" ILECs of subsidizing its rural customers. Sprint and AT&T, having presented no comparative analysis, cannot piggyback on Dr. Loube's unsupported and unsupportable assertion on this alleged subsidy flow. Not only is the possible existence of an internal urban-rural cross-subsidy completely unsubstantiated, but the record demonstrates that such a subsidy is not economically viable. No party disputes that Verizon's access line losses are greater than the RLECs',[10] placing Verizon under greater economic stress and reducing its ability to even recover its own costs – let alone to subsidize the RLECs.[11] Further, Verizon's margin analysis and financial evidence show that it is losing money both on the overall provision of rate-regulated services and on a total-company basis – so there is simply no pot of revenue on which Verizon could theoretically rely to subsidize any portion of its regulated business.

C. Exacerbating the Rate Disparities Would Be Inconsistent with Federal Reform Efforts.

The FCC is currently considering comprehensive intercarrier compensation reform that would remove the ability of some states and some carriers to extract subsidies from other states and other carriers by maintaining access rate differentials. There, multiple carriers and other stakeholders joined Verizon and a coalition of various carriers and carrier associations to present the FCC with a framework for intercarrier compensation and USF reform comprised of complementary proposals for rate-of-return and price-cap carriers.[12] That framework would

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

11 Indeed, Verizon has suffered acute line losses in urban and suburban areas, further undercutting any ability to use purported margins from those more densely populated areas to subsidize its rural customers. VZ St. 1.0 at 16. This is one of the many areas where Verizon has indicated that it needs to update the record in light of the Access Order.

12 *See* Letter from AT&T, Verizon, CenturyLink, Frontier, FairPoint, Windstream, USTelecom, National Telecommunications Cooperative Association, OPASTCO, and Western Telecommunications Alliance, to

remove access charge cross-subsidies by establishing a single nationwide terminating rate that all carriers must charge. The FCC set a very short cycle for comments on the consensus framework (as well as a plan submitted by the State Members of the Federal-State Universal Service Joint Board), which has already ended – and it has confirmed it is in the "final stage" of its decision making process.[13]

By all accounts, then, there is strong momentum for FCC action on comprehensive intercarrier reform which would potentially accomplish what only the FCC can do – ensure that Pennsylvania consumers are not required to ship subsidy payments to carriers elsewhere. As OCA confirms, the "first best solution" for access reform is to "equate all intercarrier compensation rates, both interstate and intrastate, access charge and reciprocal compensation." OCA Main Br. at 36 n. 31. Although OCA and Verizon disagree about what that uniform rate should be – OCA's witness advocates "the average of all of those existing rates" (*id.*) – OCA confirms that this Commission is not empowered to achieve the unified solution that would be optimal. *Id.* ("because of the dual jurisdiction of the FCC and the Pennsylvania Commission, it is not possible for the Pennsylvania Commission to unilaterally establish the first best solution"). Given that the Commission has not begun its deliberations yet in this case, it will therefore be appropriate to factor into this proceeding the FCC's pending decision.

It would be premature to proceed with a determination regarding Verizon's access rates here given: (i) the Commission's decision to establish an access policy that is "materially

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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 ("ABC Plan").

13 J. Genachowski *et al., Bringing Broadband to Rural America: The Home Stretch on USF and ICC Reform*, FCC blog entry dated August 8th, 2011, *available at* http://www.fcc.gov/blog/bringing-broadband-rural-america-home-stretch-usf-and-icc-reform. Chairman Genachowski has indicated that the FCC will consider an order "before the leaves fall from the trees." *See FCC Won't Consider USF-ICC Order at September Meeting*, TR's State NewsWire (Aug. 18, 2011).

different" (Access Order at 118) from the federal framework; (ii) the resulting persistence of massive access distortions that harm Verizon and its customers; (iii) the pending reconsideration of the Access Order and expected FCC action this fall; (iv) the lack of a record that engages those moving targets; and (v) the continuing inequities visited upon Verizon's customers who must ship millions of dollars annually to other carriers around the state and across the country – including such far-flung places as Texas and Mississippi – through high access charges payments and "net" contributions to the state and federal universal service funds. [14]

II. Verizon's Access Rates Are Just and Reasonable Under Pennsylvania law.

AT&T and Sprint offer up a series of claims and arguments that misstate the law and ignore or discount threshold considerations that must be part of the Commission's decision.

A. Verizon, the OCA, and OSBA Agree that the Access Order Confirms that the Commission Should Not Decrease Verizon's Access Rates at this Time.

Although their proposed analytical frameworks differ from what Verizon advocates, the OCA and OSBA agree that Verizon's intrastate switched access rates should not be unilaterally further reduced at this time. The OSBA and OCA both focus on the Commission's recent determinations in the Access Order, analogizing between the policy determinations there and those proposed here. *See* OCA Main Br. at 2-3, 23, 27-29; OSBA Main Br. at 9-12.[15]

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14 AT&T, without any explanation, asserts that Verizon's access line losses may have been caused by high switched access rates. *See* AT&T Main Br. at 2 (asserting that the "flight of consumers" from Verizon's wireline operations is "driven in large part by high wireline access charges"); *see also id.* at 15. AT&T provides no support for that assertion, and the record here does not support it. If anything, the retail rate suppression associated with the legacy regulatory paradigms – which AT&T supports here – has reduced Verizon's access lines losses. Sprint confirms that "artificially suppressed rates" can hold back competition (Sprint Main Br. at 13), but as discussed below, it nevertheless joins AT&T in arguing that Verizon's retail rate flexibility should be extremely limited.

15 If the Commission ultimately decides to reduce Verizon's traffic sensitive access rates to interstate levels, it would have to adopt the OSBA's proposal that Verizon offset that reduction with an increased carrier charge, so that Verizon would remain "revenue neutral." OSBA Main Br. at 11-12. OSBA correctly notes that Verizon's resulting carrier charge would still be much lower than what the RLECs are authorized to

By contrast, Sprint and AT&T *avoid* engaging the substance of the Access Order. AT&T barely acknowledges the existence of the seminal Order, which the Commission issued less than two months ago, and in which the Commission flatly rejected a number of AT&T and Sprint's fundamental arguments. Sprint simply points out that the Commission envisioned a separate proceeding to evaluate Verizon's access rates, and summarily asserts that "it is not productive to delve into the specifics of the RLEC Access Order." Sprint Main Br. at 19. While Verizon agrees with AT&T and Sprint about some of the deficiencies in the Access Order, it represents Pennsylvania's present access framework and cannot be ignored.

Verizon's existing access rates cannot be deemed unjust or unreasonable under the framework established in the Access Order. As OSBA observes, Verizon's current switched access rates are much lower than what the Commission has just authorized the RLECs to charge after the Access Order is finally implemented in four years.[16] They are also much lower than the level recommended by an OSBA witness in a previous proceeding in this docket.[17]

B. Sprint and AT&T Ignore and/or Misstate the Relevant Legal Framework.

1. The Outdated "Determinations" AT&T and Sprint Cite Do Not Support their Position.

While almost completely ignoring the recent Access Order, Sprint and AT&T extensively rely on the 1999 Global Order, the 2005 Recommended Decision in this proceeding, and other outdated precedent. But contrary to AT&T's and Sprint's arguments, those earlier decisions do not support their argument that this Commission should unilaterally reduce Verizon's access

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charge under the Access Order, so Verizon would still charge *by far* the lowest switched access rate in the state under OSBA's proposal.

16 OSBA calculates that reducing Verizon's usage-based access elements to Verizon's interstate levels and shifting those revenues into a slightly increased carrier charge would yield a carrier charge of **[BEGIN VERIZON PROPRIETARY]** **[END VERIZON PROPRIETARY]**, which "would be significantly lower" than the $2.50 CC set for the RLECs. *See* OSBA Main Br. at 11-12.

17 *Id.* at 12.

rates. Circumstances have changed dramatically in the intervening years, and the Commission has unambiguously clarified that the *dicta* Sprint and AT&T cite from earlier orders does not stand for what AT&T and Sprint claim.

For example, citing *dicta* from old orders and quoting from the 2005 Recommended Decision in this proceeding, AT&T suggests that the Commission has already decided Verizon's switched access rate should be reduced. *See* AT&T Main Br. at 9. And Sprint claims that a decision to require Verizon to mirror its interstate rates "without delay" has "already been reached *in this docket*." Sprint Main Br. at 8 (emphasis in original). But a decision obviously has not already been made with respect to Verizon's switched access rates, and in lifting the stay in this case the Commission appropriately called for the submission of new evidence to inform its decision. The refreshed record is crucial and relevant to the Commission's action in this phase of this proceeding because it shows that the communications industry and Verizon's circumstances have changed dramatically since those statements were made years ago. The earlier record did not reflect Verizon's massive line losses during the past decade, the downward spiral in Verizon's financial performance, or the fact that now Verizon is losing substantial amounts of money on the provision of rate-regulated services. This Commission must base its determinations on the refreshed record.[18]

Perhaps even more importantly, the Access Order makes abundantly clear that the quotations AT&T and Sprint mine from those earlier decisions do not accurately describe the Commission's policy – then or now. The Commission has just rejected the AT&T/Sprint argument in the Access Order, and in doing so made clear that Sprint and AT&T have misstated

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[18] AT&T also attempts to discredit Verizon's witness by quoting testimony he gave as an MCI witness in 2005, where Mr. Price argued then that there was no need to hold up access reform until Verizon could get relief from its regulatory obligations. *See* AT&T Main Br. at 35-36. That testimony, of course, was based on a record that did not (and could not) include the extensive evidence that now exists showing that Verizon is losing substantial amounts of money in Pennsylvania because of those burdens.

the Commission's policy. In direct contrast to AT&T's and Sprint's assertions, the Commission states that the framework it has just put in place represents this Commission's "long-established policy." Access Order at 11. The Commission should ignore AT&T's attempt to invoke outdated precedent that is squarely contradicted by the Access Order and by the refreshed record.

2. The Commission Cannot Ignore Verizon's Losses on Rate-Regulated Services When it Engages in Ratemaking.

Verizon presented with its direct testimony a TSLRIC cost study and supporting documentation, along with a margin analysis showing that Verizon's losses on the provision of rate-regulated services are approximately **[BEGIN VERIZON PROPRIETARY] END VERIZON PROPRIETARY]** annually. *See* Verizon Main Br. at 12; VZ St. 1.0 (Price/Mazziotti Direct) at 29; VZ Direct Exhibit D. Verizon complemented that cost study with financial data, including bondholder reports prepared for investors that are audited by Ernst & Young as well as annual reports prepared for this Commission, which confirm that, however one looks at the data, the inevitable conclusion is that Verizon is losing money on its Pennsylvania operations. *See* Verizon Main Br. at 12-14; VZ Rebuttal Exhibits C-1 & C-2.

Sprint's and AT&T's first and principal response is that Verizon's inability to recover its costs is purportedly "irrelevant" to this proceeding. For example AT&T argues that "[w]hatever complaints Verizion might have about non-access services are irrelevant to the issues in this case" because they are all issues that "pre-date" this proceeding and that Verizon could have sought to address previously. AT&T Main Br. at 33; *see also* Tr. at 380 (Sprint witness asserting that Verizon's financial evidence is "irrelevant" because this proceeding is limited to "rebalancing from one service to another"). That is wrong as a matter of law. As Verizon discussed in its Main Brief (at 19-20), it is black letter constitutional law that when engaged in ratemaking, this Commission may not ignore evidence of financial distress. 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).

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").[19] The fact that the Commission has yet to lift all of the legacy regulatory burdens and constraints that are contributing to Verizon's financial distress – or the fact that Verizon may seek to obtain some or all of the necessary relief at some unknown point in the future – is irrelevant to the Commission's obligation to ensure that Verizon's rate structure is compensatory *when* it engages in ratemaking.

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19 A related argument, which Sprint advanced at the hearing but has not pressed in briefing, is that by electing alternative regulation, Verizon somehow gave up the constitutional and statutory protections that require this Commission to ensure that the rates its sets are compensatory. Tr. at 207-210. OSBA also advanced that argument in written testimony (but not in briefing). *See* OSBA St. No. 1 at 20-21. That argument is meritless because both the Pennsylvania Supreme Court and the U.S. Supreme Court have unambiguously determined that it is the "end result" of a regulator's action, not the particular regulatory method employed, that matters. *Public Advocate v. Philadelphia Gas Comm'n*, 544 Pa. 129, 140, 674 A.2d 1056, 1061-62 (1996) (*quoting Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944)); *see also* Verizon Main Br. at 10-11. Chapter 30 confirms that all rates set for services regulated as "noncompetitive" must comply with the "just and reasonable standard." See 66 Pa. C.S. § 3015 (g). By invoking those protections, Verizon simply requests that the Commission comply with its obligation to ensure that Verizon has a reasonable opportunity to recover its costs; Verizon is not asking for anything that the Commission does not have both the obligation and the authority to provide under Chapter 30. As Verizon's witness noted at the hearing, the fact that alternative regulation takes Verizon out of the "rate of return" framework obviously does not mean that the rates imposed on Verizon can be unjust or unreasonable. Tr. at 207.

3. Verizon's Opportunity to Recover its Costs of Rate-Regulated Services Must Be Realistic – Not Illusory.

Verizon has made clear that all it seeks from the Commission's ratemaking determinations is a "meaningful opportunity" to recover its cost for providing rate-regulated services. *See* VZ St. 1.1 (Price/Mazziotti Rebuttal) at 44-45. Sprint, however, appears to suggest (incorrectly) that such an opportunity may not be appropriate. *See* Sprint Main Br. at 14-15.

Sprint focuses on *Pennsylvania Elec. Co. v. Penn. Pub. Util. Comm'n*, 509 Pa. 324, 502 A.2d 130 (Pa. 1985), where the Pennsylvania Supreme Court denied two electric utilities' requests to recover from their customers substantial investments in a nuclear generation facility that they had to abandon in the wake of the Three Mile Island disaster – thereby imperiling their "financial viability." *Id.* at 324. Sprint cites that case for the proposition that "like all businesses, utilities must be exposed to business risks like any other financial venture." Sprint Main Br. at 14. Sprint, however, does not explain how that principle is relevant here. Verizon does not contend that the Commission must guarantee its financial success. For example, Verizon does not contend that its consumers should be required to foot the bill if Verizon, like the appellants in *Pennsylvania Elec. Co. v. Penn. Pub. Util. Comm'n*, is subject in the future to a *force majeure* akin to the Three Mile Island disaster. Instead, Verizon is merely invoking its constitutional right to be regulated by this Commission in a way that gives Verizon a reasonable opportunity to recover its costs, including costs this Commission *itself* imposes on Verizon and over which this Commission has control.[20]

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[20] The Commission does not have control over Verizon's broadband deployment obligations, but they are part of the Chapter 30 regulatory framework under which Verizon is regulated and should be considered when addressing Verizon's overall regulatory burdens.

The U.S. Supreme Court made clear in *F.P.C. v. Hope Natural Gas*, 320 U.S. 591, 603 (1944) that although the regulator does not need to guarantee a particular return, the regulator must provide an opportunity "sufficient to ensure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." Where this Commission itself controls the regulatory burdens and constraints relevant to the financial integrity of Verizon's Pennsylvania ILECs, there is no basis for Sprint to suggest that it can exercise those powers in a way that ignores Verizon's evidence of financial distress. Sprint offers no basis to conclude that this Commission is permitted to "balance" the consumer benefits associated with unilaterally reducing Verizon's switched access rates against "Verizon's interests in returns to its investors" (Sprint Main Br. at 15) when Verizon's "returns" are negative largely *because of* regulatory burdens and constraints this Commission chooses to impose on Verizon.

C. Contrary to AT&T's Assertion, "Call Pumping" Incentives Would *Increase* Under the AT&T/Sprint Proposal.

On pages 17-18 of its Main Brief, AT&T suggests that its proposal to unilaterally reduce Verizon's access rates in isolation would reduce incentives for arbitrage, including "call pumping" schemes (in which carriers stimulate toll traffic volumes so that they can collect substantial access revenues). According to AT&T: "Less money wasted on administering an irrational system, and litigating over arbitrage activities, means more money for better pricing and investments that bring real benefits to consumers." AT&T Main Brief at 18. That makes no sense here. AT&T identifies no "money wasted" on arbitrage activities related to Verizon's switched access rates, and does not allege that Verizon is engaged in any arbitrage scheme – because it is not.[21]

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[21] Verizon confirmed in discovery that AT&T does not contend that Verizon is involved in any arbitrage schemes. *See* VZ St. 1.1 (Price/Mazziotti Rebuttal) at 44.

Moreover, AT&T has it backwards. Incentives for call pumping are primarily related to differences *among* different carriers' access rates – differences that cause pricing distortions in the market for long distance service. Specifically, if a customer's price for a long distance call is substantially below the access rate that her long distance provider is required to pay to terminate the call, then there is an opportunity for the terminating carrier (with the high access rate) to engage in call pumping. Even though the customer's long distance provider loses money every time it terminates her calls to that particular carrier, the low long distance price (caused by the fact that other terminating carriers charge more reasonable switched access rates) causes her to be insensitive to that fact. Those are the conditions under which call pumping schemes typically flourish.

And the record shows that those are *precisely* the conditions present in Pennsylvania under the disparate access rate regime that AT&T defends. Verizon's relatively low switched access rate facilitates a statewide long distance price that is substantially below the average access rate RLECs charge for terminating such long distance calls.[22] So even if on average a long distance provider makes money in Pennsylvania, when its customers place calls to the territories of RLECs with high access rates, it loses money terminating those calls. *See* Tr. at 424. And because the long distance provider is not able to pass on the high access rate to its customer, the customer is not even aware that she is causing her long distance provider to lose money. That situation – which is already present in Pennsylvania – sets the stage for arbitrage

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22 Specifically, the data AT&T presented indicate that in 2008 it paid Verizon **[BEGIN AT&T PROPRIETARY]** **[END AT&T PROPRIETARY]** for switched access, which pulled the state-wide average rate paid for switched access down to **[BEGIN AT&T PROPRIETARY]** **[END AT&T PROPRIETARY]**. The resulting state-wide long distance price AT&T charged its retail customers was **[BEGIN AT&T PROPRIETARY]** **[END AT&T PROPRIETARY]**, which is below the average access rate charged by the RLECs. *See* AT&T Surreburral Attachment D, Part 2, page 16 of 20. Some RLECs charge rates that range as high as $0.11 per minute for just their traffic-sensitive rate elements, and RLECs' carrier charges range as high as $17.99 per month. *See* Access Order at 12.

activity. Verizon's proposal that the Commission reduce existing rate disparities would *reduce* incentives for arbitrage, whereas AT&T's proposal to increase existing access rate disparities by unilaterally reducing Verizon's rates would *increase* arbitrage incentives. That is yet another important policy reason to reject the Sprint/AT&T proposal.

D. The Other Arguments Advanced by Sprint and AT&T Are Misguided.

1. AT&T's and Sprint's Discussions of the Benefits of Access Reductions Lack Balance.

Sprint and AT&T argue that reducing Verizon's access rates would result in consumer benefits. Sprint Main Br. at 9-11; AT&T Main Br. at 12-14, 25-26. Verizon has never contested that reducing switched access rates can benefit consumers if all carriers' rates are reduced in parallel to a common level, but the Commission must approach access reform in a rational way that treats all carriers equally and that does not result in collateral damage that would outweigh the benefits of the reductions. As discussed throughout this brief and in Verizon's Main Brief, under the unique circumstances present here it would be a step in the wrong direction to require Verizon to unilaterally further reduce its already-low switched access rates in Pennsylvania without also alleviating the regulatory burdens and constraints that prevent Verizon from recovering Commission-imposed costs.

2. Verizon's Access Rates in Pennsylvania Are Not Outliers

Both Sprint and AT&T argue that this Commission should look to other states in order to evaluate what is a reasonable switched access rate for Verizon in Pennsylvania. *See* Sprint Main Br. at 20-25; AT&T St. 1.0 (Nurse/Oyefusi Direct) at 20. Specifically, they argue that their mirroring proposal is reasonable because it is – they allege – a framework that a number of other states have adopted. *Id.* That argument is flawed for numerous reasons.

First, the most relevant rate comparison is obviously not to what other state commissions may have determined, but to what other Pennsylvania carriers charge – and this Commission has just determined that mirroring is *not* appropriate under Pennsylvania law.

Second, AT&T and Sprint do not discuss whether and to what extent circumstances here – including Verizon's cost and financial evidence as well as its unique regulatory burdens – are similar to those present in any of the so-called "mirroring" states. Any proposed analogy to another state is unpersuasive absent some showing that the relevant circumstances are at least roughly similar.

Third, AT&T and Sprint significantly overstate the extent to which states have actually implemented mirroring policies. For example, AT&T attached to its direct testimony a document entitled "States With Intrastate/Interstate Access Parity," which purports to be a compilation of various states' access policies. *See* AT&T Panel Direct Exhibit G. This was apparently offered to support AT&T's argument that mirroring is pervasive across the county. But even assuming that states AT&T placed in the "interstate parity" category belong there, only about half of the states in the country made it onto AT&T "parity" list. The other half has *not* implemented mirroring policies – a fact that undercuts the notion that mirroring is the dominant policy across the country.

Finally, AT&T places many states in the "mirroring" category that should not be there. For example, almost none of the states that AT&T includes in its compilation has moved toward a uniform state-wide rate or has otherwise undertaken comprehensive reform. In fact, while AT&T here points to the compilation as evidence that mirroring is extremely common, it presented the exact same document to the FCC in order to make the opposite point. In October 2010, AT&T submitted to the FCC an *ex parte* letter in which it attached the "States With

Intrastate/Interstate Access Parity" document, and pointed to that document for the following conclusion:

> [W]hile many states had some access reform in the last six years and several others have open proceedings, *only a few states* have moved to complete parity between intrastate and interstate switched access rates and structures.[23]

Accordingly, AT&T and Sprint have not presented evidence that Verizon's access rates in Pennsylvania are an outlier compared to other states or that the actions of other state commissions are relevant to the reasonableness determination this Commission must make based on Verizon's unique circumstances here. Given the reality of what other regulators and other states have (or have not) done, there is no basis for AT&T's elevated rhetoric about Verizon earning a "windfall" (AT&T Main Br. at 4) on its comparatively low (well under $0.02 per minute) switched access rate in Pennsylvania.

3. Comparisons to Verizon's Reciprocal Compensation and Other Rates Are Not Relevant to the Commission's Determination Here.

Sprint argues that Verizon's switched access rates should be reduced because they are above what Verizon charges for other similar functions. *See* Sprint Main Br. at 25-28. Verizon's switched access rates are indeed above its costs for providing switched access,[24] but that is not determinative given the circumstances present here. Sprint cites no authority indicating that a regulator must set a particular rate at a cost-based level; as discussed above, this Commission's obligation is to ensure that Verizon has a reasonable opportunity to recover its costs for the provision of the *basket* of intrastate services whose rates this Commission regulates.

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23 *See* Verizon Rebuttal Exhibit F (emphasis added).

24 In fact, Verizon did not produce a cost study modeling its costs for switched access because the results of such a study would have been immaterial to the conclusion that its cost study reached, i.e., that Verizon is losing substantial amounts of money on the provision of intrastate rate-regulated services. See VZ St. 1.0 (Price/Mazziotti) at 29-30. In reaching that conclusion, Verizon's margin analysis included the revenues associated with switched access services, but did not include any of their costs – effectively assuming, in order to provide a particularly conservative analysis, that the costs are zero. *Id.*

Although Verizon supports moving switched access rates closer to cost under the appropriate circumstances, as discussed throughout this brief the unique circumstances presented here do not support a unilateral reduction in Verizon access rates.

4. AT&T and Sprint Misstate Verizon's Advocacy Elsewhere.

AT&T accuses Verizon of "hypocrisy" for allegedly supporting access reductions elsewhere, while resisting unilateral reductions here. *See, e.g.*, AT&T Main Br. at 30; *see also* Appleby Direct Testimony on behalf of Sprint at 4-5. That accusation is simply wrong. Verizon's consistent advocacy regarding switched access rates in other states and in the RLEC case is the same as its advocacy here: state commissions should put in place uniform policies that ensure that all companies are playing on a level playing field. Verizon has therefore advocated, across the country, uniform access reform. And, as a reasonable interim step towards that goal, Verizon has consistently advocated first addressing the most egregious access rates that cause the greatest distortions – which in this case are the RLECs' extremely high switched access rates.[25] AT&T and Sprint do not cite (nor can they cite) a single instance where Verizon has advocated unilaterally reducing a single carrier's switched access rates under the circumstances present here.

III. No Party Undercuts the Evidence that Verizon's Pennsylvania ILECs Are Losing Money Both on Rate-Regulated Services and on an Overall Basis.

AT&T, joined sporadically by the OCA and Sprint, attempts to discredit Verizon's economic evidence through conclusory statements while virtually ignoring Verizon's financial evidence.[26] As discussed below, the criticisms lack record evidence support and sound analysis.

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25 Not only are the RLECs' rates much higher than Verizon's, but the economic distortions they create in an absolute sense are greater. *See* VZ St. 1.1 (Price/Mazziotti Rebuttal) at 45.

26 In its brief, Sprint does not attempt to identify any deficiencies in Verizon's economic evidence. As Verizon has explained, the criticisms Sprint's witness raised about Verizon's financial presentation were entirely unsupported and unsupportable. *See* Verizon Main Br. at 14 n.16. AT&T's brief similarly ignores

A. Criticisms of Verizon's Cost Study Are Misguided, and Would Not Alter the Study's Conclusions.

1. The Argument that Verizon "Misallocated" Costs to Rate-Regulated Services Has Been Repeatedly and Thoroughly Discredited.

The principal criticism leveled at Verizon's cost study is that it purportedly misallocates to basic local service certain "shared and common" costs associated with Verizon's network in Pennsylvania. AT&T claims that "Verizon has modeled a network capable of providing advanced services like multi-megabit Internet service and 'FiOS' (Verizon's video service)," but claims that Verizon's study "improperly assumes that the network is used exclusively for basic service." AT&T St. 1.0 (Nurse/Oyefusi Direct) at 41. AT&T then accuses Verizon of "allocating all of the shared costs associated with basic and advanced network capabilities solely to the basic services." *Id.* Sprint and OCA make the same assertion. *See* OCA Main Br. at 29-31; Appleby Direct at 26-27; Appleby Rebuttal at 6. But as Verizon's witnesses have *repeatedly* explained, that criticism is based on a fundamental misunderstanding of how Verizon's cost study was conducted. The study includes *only* that portion of the shared costs associated with the provision of R-1 and B-1 service because it is a "bottoms up" study that only models costs related to the provision of regulated basic local exchange service. Verizon's witnesses clearly explained that fact in their rebuttal testimony (*see* VZ St. 1.1 (Price/Mazziotti Rebuttal) at 20-23) and again at the hearing (*see* Tr. at 115-19).

In fact, contrary to AT&T's assertion that Verizon misallocated the costs of poles and conduit (AT&T St. 3.0 (Nurse/Oyefusi Surrebuttal) at 25), the fact is that *78 percent* of the cost of poles and conduit is allocated to services other than R-1 and B-1 services.[27] That is

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Verizon's financial evidence, and AT&T devotes only a single sentence of its brief to Verizon's cost study. *See* AT&T Main Br. at 35 (generally referencing AT&T's testimony).

[27] Tr. at 116. AT&T apparently noticed a factor in Verizon's study described as "pole-sharing" and misunderstood that factor to involve cost-sharing across different Verizon services. In fact, that term refers

inconsistent with the alleged cost "misallocation." Moreover, Verizon modeled basic exchange loops using *only* copper distribution because copper continues to be "the most cost effective way to provide voice-only service." *See* VZ St. 1.1 (Price/Mazziotti Rebuttal) at 22; *see also* VZ St. 1.3 (Price/Mazziotti Surrebuttal) at 5; Tr. at 115-18. By focusing on copper, Verizon's cost study is significantly conservative. *See* VZ St. 1.1 (Price/Mazziotti Rebuttal) at 22. No opposing witness refuted Verizon's witnesses' *repeated* explanations regarding what the cost study actually represents and why the misallocation criticism is wrong, so there is no basis to give any weight to that fully discredited argument.[28]

2. Verizon Employed Conservative Assumptions and Methodologies that Actually Understate Its Losses.

AT&T also criticizes Verizon's cost model on the ground that it should have been designed to capture the "economies of scope when the network is designed to provide all services for which it is capable, including advanced service and an appropriate portion of its joint investments is assigned to all services for which they are incurred." AT&T St. 1.0 (Nurse/Oyefusi Direct) at 41. That criticism is ironic because, in order to conservatively estimate the costs of basic local service, that is *precisely* what Verizon did: Verizon modeled a network based on total demand for voice services (including all voice service provided over Verizon's FiOS network), but modeled that network as an all-copper network (*i.e.*, without any fiber-to-the-home investments). *See, e.g.*, VZ St. 1.1 (Price/Mazziotti Rebuttal) at 21; Tr. at 115-

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to sharing agreements between Verizon and electricity companies for the use of poles and conduit. Tr. at 117. Consistent with Verizon's conservative approach to conducting the cost study, those pole sharing agreements were factored into the costs of poles and conduit in order to reduce the costs associated with the local loop. AT&T's fundamental misunderstanding of that fact highlights that its witnesses do not appear to have seriously analyzed Verizon's cost study.

28 As discussed above, neither AT&T nor Sprint presses its misallocation criticism in its main brief. OCA, however, continues to argue that "Verizon arbitrarily assigns all of its shared network costs to basic local service." OCA Main Br. at 33 (*quoting* Loube Surrebuttal Testimony at 2). Indeed, OCA's entire critique of Verizon's cost study – including its attempt to arbitrarily "re-assign" costs to different services – is based on this fundamental misunderstanding of what the study actually modeled. *See* OCA Main Br. at 29-35.

19. And, as discussed above, Verizon *reduced* the shared and common costs associated with basic local service by *only* taking the portion of those costs commensurate with basic local service's share of total services.

Moreover, to present a particularly conservative analysis, Verizon expanded its cost study and margin analysis to include not only R-1 and B-1 services, but also all non-rate regulated intrastate services (i.e., services classified as "competitive" and thus not subject to rate regulation) associated with such lines. *See* VZ St. 1.0 (Price/Mazziotti Direct) at 31-32. Margins from those services (including vertical features, directory assistance, intraLATA toll and directory listings) are included in Verizon's profitability analysis, making a total contribution of about **[BEGIN VERIZON PROPRIETARY]** **[END VERIZON PROPRIETARY]** to Verizon's margin analysis. *Id.* Even though there is no legal or policy basis to consider contributions from such non-rate regulated services when engaged in ratemaking, Verizon included them in order to demonstrate that even if such contributions are included, the results would not change. *Id.* at 32. The other parties ignore this aspect of Verizon's margin analysis.[29]

3. Even if the Criticisms Had Merit, No Party Suggests that Correcting for them Would Alter the Study's Results.

Even if the criticisms of Verizon's cost study had merit (and they do not), no party adjusted for the alleged deficiencies in order to provide the Commission with an alternative calculation of the costs of basic local service. There is no basis to conclude that the substantial

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29 The rest of the criticisms of Verizon's cost study are "cut and pasted" from other proceedings and/or are irrelevant here. *See generally*, VZ St. 1.1 (Price/Mazziotti Rebuttal) at 18-25; VZ St. 1.3 (Price/Mazziotti Surrebuttal) at 4-6. For example, AT&T cited some concerns that the Michigan commission had about Verizon's study methodology (Nurse/Oyefusi Direct at 42), without acknowledging that the study submitted to this Commission *includes* the methodology changes that had been required in Michigan. *See* VZ St. 1.1 (Price/Mazziotti Rebuttal at 24.)

losses the study shows would be reversed even if the criticisms of the study were both valid and fully accounted for in a revised cost study. That is particularly true given the various assumptions and techniques Verizon employed in order to present a particularly conservative analysis. The Consumer Advocate's economist – not a champion of Verizon's advocacy here or in many other proceedings – confirmed that Verizon's cost study is "close enough" for purposes of concluding that Verizon's switched access rates should not be reduced. Tr. at 348. Against that backdrop, there is no basis for the Commission to find that Verizon's cost study and margin analysis fail to establish that Verizon is losing significant amounts of money on the provision of services that are rate-regulated by this Commission.

B. The Financial Data Overwhelmingly Confirm that the Verizon ILECs Are Losing Money in Pennsylvania.

In addition to presenting its cost study and margin analysis, Verizon presented financial evidence to show that Verizon's financial position has deteriorated consistently in recent years, and that at this point Verizon is losing money in Pennsylvania on an overall basis. *See* VZ St. 1.0 (Price/Mazziotti Direct) at 19-22; VZ St. 1.1 (Price/Mazziotti Rebuttal) at 7-18. As discussed above, neither AT&T nor Sprint raise any concerns in their briefs about Verizon's financial evidence. Only OCA critiques Verizon's financial presentation, but its meritless arguments evidence a lack of understanding of the financial evidence.

As an initial matter, OCA's concern regarding Verizon's financial presentation addresses only the annual reports that Verizon files with this Commission. *See* OCA Main Br. at 44-46. OCA's brief does not address the audited financial statements that Verizon Pennsylvania Inc. prepares for its investors ("Bondholder Reports"), which show a net loss of $18 million in 2009 that worsened to $122 million in 2010.[30] OCA's witness confirmed on cross examination that he

[30] *See* VZ Rebuttal Ex. C-2, p. 3.

is aware of no basis to question the accuracy of the Bondholder Reports. *Id.* at 361. That is unsurprising because the reports are prepared using U.S. generally accepted accounting principles ("GAAP") and are audited by Ernst & Young, which concluded – pursuant to its fiduciary duty to Verizon Pennsylvania Inc.'s investors – that these Bondholder Reports "present fairly, in all material respects, the consolidated financial position of Verizon Pennsylvania...." *See* Verizon Rebuttal Ex. C-2 at 2.[31] Accordingly, no party even asserts that there is a basis to mistrust the information in the audited Bondholder Reports.

The financial reports addressed in OCA's testimony are filed by Verizon with the Commission pursuant to 52 Pa. Code § 63.36. They are filed in conformance with the regulatory accounting rules that this Commission requires Verizon to follow, and the Commission has determined that they provide the information it needs to "undertake a meaningful review of a company's financial circumstances to fulfill our statutory duty of requiring reasonable, safe, and reliable telecommunications service."[32] The OCA has previously argued – and this Commission has agreed – that the Commission must review the annual reports to "evaluate the [] financial health" of local exchange carriers.[33] So as an initial matter, it is incongruous for OCA to assert here that to be useful to the Commission, Verizon would need to completely re-do the annual reports by conducting a "proper separations allocation" that OCA admits "would be time-consuming and burdensome." OCA Main Br. at 45.

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31 Also, it is noteworthy that OCA's witness admitted during the hearing that he has not examined any of the workpapers underlying Verizon's financial presentation – either its Bondholder Reports or the annual reports filed with the Commission. Dr. Loube testified that prior to relying on the annual reports that Verizon files with the Commission, the Commission should "examine it" and "get the workpapers behind it" (Tr. at 351), but he admitted that neither OCA nor any other party requested any of Verizon's backup workpapers in discovery. *Id.* at 362.

32 *See PUC Filing and Reporting Requirements on Local Exchange Carriers*, Docket No. M-00041857 (Opinion and Order entered October 5, 2005) at 16.

33 *Id.* at 13, n. 38.

OCA's concerns about cost allocation seem to be based on its claim that in presenting the financial analyses in the annual reports, Verizon purportedly "allocated to the state jurisdiction" an excessive amount of costs. *See* OCA Main Br. at 44. OCA therefore concludes that the annual reports do not confirm that Verizon is losing money on its intrastate regulated operations. *Id.* OCA attempts to back up its separations argument by observing that Verizon's non-regulated affiliate, Verizon Online Pennsylvania ("VOL"), has been consistently operating at a loss – a fact that OCA apparently cites to suggest that Verizon's overall losses are caused by substantial losses associated with Verizon's non-jurisdictional operations. OCA Main Br. at 45.

Those criticisms are wrong and, more importantly, miss the point of Verizon's use of the annual reports. First of all, by the Commission's own requirements these annual reports are stated on a "total company" basis, and do not attempt any allocation of costs. Moreover, Verizon cited the annual reports principally to confirm that it is losing money on an overall basis and that its financial position has been steadily deteriorating. *See* Verizon Main Br. at 12-13. OCA's criticisms do not affect those crucial facts, which provide a "reality check" on Verizon's cost study and margin analysis, demonstrating that there can be no merit to Sprint's suggestion that Verizon earns substantial margins on non-jurisdictional services that can subsidize Verizon's provision of intrastate rate-regulated services. There is no dispute that the annual reports and Bondholder Reports include *all* services, including FiOS video and broadband services[34] – so even if it were appropriate for the Commission to consider earnings from such non-jurisdictional services when engaged in ratemaking (which it may not do), they demonstrate that any margins from those services are insufficient to subsidize Verizon's money-losing operations on rate-

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[34] *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 & C-2, page (stating that the Annual Report submitted by Verizon Pennsylvania to this Commission is done on a "Total Company" basis).

regulated services, nor given that those services are intensively competitive is it even conceivable that they are capable of subsidizing the regulated services.

OCA does not suggest that any of those key facts are inaccurate. To the contrary, OCA's argument that Verizon's overall losses may be driven by the substantial losses sustained by its unregulated VOL affiliate is directly at odds with Sprint's claim that Verizon inappropriately ignored revenue from its non-jurisdictional operations. In any event, OCA's observation that Verizon's VOL affiliate has consistently sustained substantial losses in Pennsylvania does not mean that Verizon is "doing fine" with respect to its intrastate operations.[35] First, even if the intrastate jurisdictional earnings were positive (and OCA makes no such showing), that would be consistent with the cost study's results, which show that Verizon is losing substantial amounts of money on the portion of intrastate services that are *rate regulated* by this Commission. As discussed above and in Verizon's Main Brief, any earnings from services (intrastate or otherwise) that are not rate-regulated cannot be relied on by this Commission to subsidize rate-regulated services.

But much more importantly, the numbers simply do not support a conclusion that the VOL affiliate's losses drive Verizon's overall loss. Line 27 of the Income Statement in Verizon's annual report[36] shows the Verizon ILECs' Net Operating Income, which represents income prior to accounting for losses associated with VOL.[37] That Net Operating Income line item has consistently deteriorated over the last ten years – from over $500 million at the

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35 In any event, VOL's losses are not irrelevant under the unique circumstances of this case. The unrefuted record shows that Verizon's compliance with its statutory broadband availability commitments is often uneconomic, having been undertaken because of regulatory requirements despite the fact that there was not always a "business case" for the deployment. VZ St. 1.0 at 47. To the extent VOL's losses are reflected in the total company results and are caused by this asymmetric regulatory burden, they are relevant to the overall analysis.

36 *See* Verizon Rebuttal Exhibit C-1.

37 Those losses are shown on line 33 – Equity in Earnings of Affiliate Companies. *See* Tr. at 229-30.

beginning of the decade to *negative* $57 million in 2010.[38] Given that the decline in Net Operating Income is independent of its losses on affiliated operations, OCA is incorrect to assert that Verizon's overall losses are caused by VOL's losses.

As Verizon noted in its Main Brief, all of the extensive economic evidence presented in this proceeding (*e.g.*, cost study, margin analysis, 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). *See* Verizon Main Br. at 13-14. There can be no serious doubt that Verizon is losing money on its Pennsylvania operations and is experiencing financial distress.

IV. Before Considering Further Reductions in Verizon's Access Rates, the Commission Must Eliminate the Legacy Regulatory Burdens that Harm Verizon and its Customers.

A. The Record Here Supports Complete Retail Rate Flexibility, Not the Continued Prescriptive Rate Caps that Some Parties Advocate.

The intensely competitive market in which Verizon operates forecloses the possibility that any pricing decision – whether made by a regulator or by a marketing executive – can be assumed to result in a particular level of revenue. Verizon needs the flexibility to experiment with different price levels and structures, and to adjust them rapidly if they do not work out or if competitive conditions change. Given the uncontested fact that Verizon is subject to intense ubiquitous competition, the Commission should eliminate outmoded pricing constraints regardless of its access policy determinations – but it particularly must do so to the extent it decides to reduce Verizon's switched access rates in the future.

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38 *See* Verizon Rebuttal Exhibit B.

In a feigned attempt to "protect" Pennsylvania consumers, AT&T insists that if the Commission reduces Verizon's access rates to interstate levels, Verizon's additional retail pricing flexibility can and should be extremely limited. *See* AT&T Main Br. at 33. Indeed, AT&T asserts that its proposal would affect Verizon's retail rates by "less than a dollar per line per month." AT&T Main Br. at 1. Not only is that calculation highly misleading, but the entire framework AT&T advocates is inappropriate because it would continue to regulate Verizon as though it were a monopolist. Given Verizon's unique circumstances and the fact that it is subject to ubiquitous intense competition throughout its service territory, it is affirmatively harmful to Verizon and to consumers to subject Verizon to *any* retail pricing constraints – let alone to impose AT&T's proposed formula. *See* VZ St. 1.0 (Price/Mazziotti Direct) at 42-43.

AT&T insists that the Commission should limit Verizon's retail rate flexibility to a very narrow "rebalancing" opportunity, and it further argues that Verizon should be expected to "rebalance" by increasing rates for services already classified as "competitive," *i.e.*, services for which Verizon already has pricing flexibility. *See* AT&T St. 3.0 (Nurse/Oyefusi Surrebuttal) at 7-8. In other words, AT&T would minimize Verizon's ability to increase rates still classified as non-competitive, for which Verizon does not otherwise have pricing flexibility. That is both factually and legally unsupportable. As a matter of economics, a regulator cannot do a better job than a profit-maximizing firm of developing and implementing pricing strategies that maximize its earnings (*see, e.g.*, Tr. at 294), and AT&T does not argue otherwise. AT&T provides no evidence that Verizon could earn additional margins from any services for which Verizon *already* has pricing flexibility. So even if AT&T's position were legally sound, the

"opportunity" presented for Verizon to increase its revenues from non-rate regulated services would be illusory.[39]

Moreover, AT&T's argument has already been rejected by this Commission, by Judges Fordham and Melillo, and by the Commonwealth Court. Indeed, AT&T continues to press this argument even though the Commission just stated in its Access Order that "[w]e shall adopt the ALJ's recommendation that concluded that revenue neutral rebalancing may be accomplished only through allowed increases in noncompetitive services to offset reductions to access charges, rather than through consideration of non-jurisdictional or competitive revenues." (RLEC Access Order at 127). Judges Fordham and Melillo confirmed that any rebalancing should occur only to lines classified as "non-competitive." *See* Recommended Decision of ALJ Fordham (Dec. 7, 2005) at 67, 98-99; Recommended Decision of ALJ Melillo (Aug. 3, 2010) at 98-99. The Commonwealth Court has confirmed that determination. *See Buffalo Valley Tel. Co. v. Penn. Pub. Util. Comm'n*, 990 A.2d 67, 80 (Pa. Commw. Ct. 2009). Those commonsense interpretations of Section 3017 are underscored by the constitutional principle that a regulator cannot rely on earnings from services whose rates it does not control when establishing a rate structure. *See, e.g., Brooks-Scanlon Co. v. Railroad Comm'n of Louisiana,* 251 U.S. 396, 399 (1920).[40] Accordingly, as a matter of Pennsylvania law, to the extent any of Verizon's retail

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39 Similarly, Sprint asserts that "if Verizon elects to, it is well able to spread the impact of its access increases across its wide array of services regardless of whether the Commission is able to order it to take such action." *See* Sprint Main Br. at 29. Sprint offers no evidence or analysis to support that conclusory assertion.

40 The OSBA argues that if access rates are reduced – which it opposes – the Commission should prevent Verizon from rebalancing all lost revenue by raising rates of services regulated as "noncompetitive." OSBA Main Br. at 12-17; *see also* Sprint Main Br. at 30. It asserts that because some of the lost access revenue would come from lines that are regulated as competitive (i.e., "contract customers" whose packages have been price-deregulated), rebalancing to only "noncompetitive" lines would violate the prohibition on subsidizing "competitive" services with revenue from "noncompetitive" ones. *Id.* That argument is entirely unsupported. OSBA presents no evidence that Verizon would be providing any service regulated as "competitive," such as service to contract customers, at a subsidized (i.e., below-cost) price. Moreover, Verizon's margin analysis shows that Verizon is losing money on the basket of rate-

services remain price constrained under a "non-competitive" classification, Verizon must be afforded the maximum opportunity to raise the rates of such services to recover all lost access revenue from any Commission-imposed access charge reduction.

AT&T acknowledges that if rebalancing occurs over only the lines purchasing services that continue to be subject to rate regulation by this Commission, the retail price increase – again, under the monopoly assumptions that AT&T employs – would be **[BEGIN VERIZON PROPRIETARY]** **[END VERIZON PROPRIETARY]** per month. *See* AT&T St. 3.0 (Nurse/Oyefusi Surrebuttal) at 6. And that calculation is itself understated because it does not include revenue from "non-usage based" rate elements, which AT&T (at the last minute) asserted should also be reduced in this proceeding.[41] Accordingly, AT&T's assertion that its mirroring proposal could be adopted by this Commission for "under a dollar per line per month" (AT&T Main Br. at 1) is a significant misstatement.

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regulated services (i.e., services still regulated as "noncompetitive"), so there is no chance that those services could possibly subsidize any services regulated as "competitive." To the contrary, making up lost revenue from one rate-regulated service (access charge reductions) with revenue from a non-rate regulated service, as OSBA suggests, would require the company to subsidize its *rate-regulated services* with revenue from *its non-rate regulated services* – which would violate both constitutional requirements and the precedent interpreting Section 3017(a) to require rebalancing among rate-regulated services. OSBA does not back up its suggestion that increasing the rates for rate-regulated services that are artificially suppressed by this Commission's regulation would constitute "classic monopoly behavior" (*id.* at 13).

41 As Verizon's witness explained at the hearing, Verizon provided that calculation making clear that it was based only on expected revenue losses associated with Verizon's "usage-sensitive" rate elements and its carrier charge, not taking into account revenue associated with non-usage sensitive elements such as entrance facilities or dedicated transport facilities. Tr. at 108-114. Although the other parties appeared to adopt that same framework in their direct and rebuttal testimony (*see* Tr. at 108-09), in its surrebuttal testimony (at page 8, note 6) AT&T claimed – for the first time – that in fact entrance facilities and dedicated transport *should* be reduced in this proceeding. Tr. at 110. That last-minute assertion creates substantial policy issues that could not be addressed during the written testimony phase of the proceeding, including the fact that in Pennsylvania there is substantial competition for the provision of entrance facilities and dedicated transport. *See* Tr. at 111-12. Accordingly, there is no record to support, for example, a finding that given competitive conditions in Pennsylvania those particular services can be classified as "monopoly function[s]" (Sprint Main Br. at 9) or that purchasers of those services are "captive customers" (AT&T Main Br. at 17). Moreover, there is no dispute that the amount of rebalancing would further increase if revenue from those rate elements is also reduced. *See* Tr. at 113-14.

But even more problematic than AT&T's mathematical gamesmanship is its insistence that the Commission should embrace a monopoly framework with respect to Verizon's retail operations in Pennsylvania. The reality is that Verizon's ILECs in Pennsylvania are subjected to intense competitive pressures which constrain prices and make the sorts of rate caps AT&T advocates both unnecessary and harmful. Neither Verizon nor AT&T nor any regulator can know, given the complex and evolving nature of the competitive market, what price level for any particular service might provide Verizon a realistic opportunity to increase its margins by an amount that would allow Verizon to remain whole. Given the record presented here, retail pricing flexibility should be robust so that Verizon can start to operate like its competitors operate in this era of unrestricted competition.

B. The Commission Should Not Simply Ignore the Harms Caused by Legacy Regulatory Burdens and Constraints.

Although Sprint and AT&T urge the Commission to reduce Verizon's switched access rates based on arguments of consumer benefits, in the same breath they urge the Commission to ignore the extensive evidence that the Commission's regulation imposes on Verizon a unique set of asymmetrical regulatory constraints and burdens that are creating substantial financial distress, which in turn have a harmful impact on consumers. AT&T, for example, asserts that "Verizon's complaints about local service regulation have no place in this access proceeding." AT&T Main Br. at 32[42]; *see also* Sprint Main Br. at 30-31.[43]

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42 AT&T criticizes Verizon for complaining about service regulation here, given that Verizon urged the Commission in the RLEC proceeding not to address assertions by CenturyLink that access reform there should be delayed until the Commission could address the issue of outdated ILEC regulatory burdens. *See* AT&T Main Br. at 35 n.133 (*citing* AT&T Cross Ex. 1) (Price testimony in RLEC proceeding responding to CenturyLink's assertions). The crucial difference is that – as AT&T pointed out in the RLEC proceeding – CenturyLink provided no evidence that it was experiencing financial distress or losing money on rate-regulated services. *See* Verizon Main Br. at 17-18. Moreover, CenturyLink's access rates are multiples higher than Verizon's.

43 Sprint mischaracterizes Verizon's position by asserting that Verizon wants the Commission to "relieve Verizon of its COLR obligations." Sprint Main Br. at 30-31. Sprint provides no citation for that assertion,

As Verizon has explained in detail, regulatory burdens applied uniquely to Verizon 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. VZ St. 1.0 (Price/Mazziotti Direct) at 34-49. One important example is that under the existing regulatory paradigm in Pennsylvania, Verizon must obtain Commission approval to discontinue an outdated service that customers no longer demand, and for which competitive alternatives exist.[44] 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."[45] 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).

Verizon's witnesses have quantified the harmful effects of some of Verizon's regulatory burdens, and explained in detail how the rest adversely affect Verizon and Verizon's customers.

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which is wrong. Nowhere in this proceeding has Verizon argued it may have a "COLR" obligation under Pennsylvania law. What Verizon has argued is that it is subject to various needless asymmetric regulatory burdens, as detailed in its testimony.

44 66 Pa. C.S. § 1102(a)(2).

45 *See Application of Hillside Estates Water System*, 1997 Pa. PUC LEXIS 23 (Initial Decision of ALJ Michael C. Schnierle isued 1997) at *10 (*citing Re Megargel's Golf, Inc.*, 59 Pa.P.U.C. 517, 522 (1985)).

See, e.g., VZ St. 1.0 (Price/Mazziotti Direct) at 35-42 (micromanagement of customer relationship to which competitors are not subject), 42-43 (retail price constraints to which competitors are not subjected), 43-44 (net transfer payments to other Pennsylvania carriers that disproportionately harm Verizon and its customers), 45-48 (infrastructural deployment requirements that apply uniquely Verizon even where there is no "business case" to deploy), & 48 (regulatory assessments that uniquely affect Verizon); *see also* Verizon Main Br. at 26-35.

OCA argues in favor of continuing to impose monopoly regulation on Verizon, arguing that Verizon has "benefitted from monopoly regulation by being granted the opportunity to earn a regulated return in its exclusive territory." *See* OCA Main Br. at 41. But even if OCA had presented evidence of the alleged "benefits" (and it has not), it makes no sense to continue to saddle Verizon with that legacy monopoly regulation now that Verizon obviously does not benefit from an "exclusive territory."

OCA also suggests that monopoly regulation is not in fact burdensome, noting that Verizon has pricing flexibility for many services and citing a few examples of regulatory vehicles that Verizon in some instances may employ to get permission for particular business decisions. *See* OCA Main Br. at 41-42. OCA even suggests that Verizon "can actually benefit" from monopoly regulation because, for example, consumers supposedly "may favor Verizon services over the services of other companies because they know there are public agencies who will help them resolve any problems if they arise." *Id.* at 43. Those arguments are out of touch with contemporary reality. Verizon understands and has extensively articulated the harms caused by monopoly regulation, and Verizon – as the regulated company – does not perceive the continuing "benefits" that OCA claims it enjoys. VZ St. 1.0 (Price/Mazziotti Direct) at 34-49; Tr. at 241-248. As Verizon's witnesses explained in detail, Pennsylvania consumers will benefit

from a regulatory approach that facilitates, rather than inhibits, the transition to a robust and modern communications industry. Even where there are *regulatory* vehicles available to request and sometimes receive permission to make modifications to certain prescriptive requirements, complying with myriad regulatory requirements diverts attention and resources away from investing in customers and innovating. *See* VZ St. 1.0 (Price/Mazziotti Direct) at 49-51. And even more importantly, in a competitive environment, companies are best able to meet customer expectations when they are free from excessive and unneeded regulation. *Id.* at 35-41. Verizon's witnesses provided numerous examples – ranging from difficulties engaging in common practices such as call recording for quality assurance purposes to prescriptive mandates that services be provided in ways that are not optimal for customers – of regulation that degrades Verizon's ability to provide customers the service they demand. *Id.*

OCA particularly misses the point in stressing that Verizon was unable to identify "the number of employee hours and the administrative costs associated with their compliance with each of the regulatory obligations they seek to eliminate." OCA Main Br. at 43. Of course Verizon cannot provide the sort of quantification OCA requested, but that does not mean that placing Verizon in regulatory straightjacket comprised of constraints and requirements developed during the monopoly era makes any sense.[46] As Verizon's witness explained when asked at hearing to quantify the costs associated with what OCA itself described as a "laundry list" of regulatory requirements:

> Not to be cute, but I think you're missing the point. The point is that each and every item in this list is something that Verizon objects to. It's the question of whether, in a competitive market, each and every one of these things need to be mandated by the regulatory authority such that Verizon

[46] As Verizon's witness explained, Verizon was unable in discovery to put a dollar value on each and every one of the regulatory burdens that exist because that would require "expending enormous resources." Tr. at 188.

> has to exert energy, time, and effort in making sure that it is complying with these external regulations.[47]

Mr. Price then went on to provide a concrete example of how an item on OCA's "laundry list" of requirements hampers Verizon's ability to operate its business competitively. Tr. at 242-43; *see also* Tr. at 198-200 (explaining how the "time to repair" service regulation can impede efforts to optimize customers' experiences).[48] The fact is that regulation of Verizon permeates every aspect of Verizon's business and does not similarly affect its competitors. Customers are affirmatively hurt by all of the legacy regulation imposed uniquely on Verizon because (i) it is ultimately paid for by customers and (ii) it replaces *customers'* preferences with what regulators have assumed (often many years ago) that customers might want. In a competitive market where customers have options, they will benefit from a lighter regulatory touch in which the Commission lets *them* drive Verizon's development and provision of services, rather than micromanaging Verizon's operations and its customer interactions.

CONCLUSION

For the reasons set forth above and in Verizon's Main Brief, 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 unless it does so on a uniform basis with other ILECs and first eliminates the legacy regulatory constraints and burdens that are causing substantial losses on rate-regulated services.

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47 Tr. at 242.

48 Verizon explained in detail in its Main Brief and its testimony how imposing prescriptive standards with respect to Verizon's interactions with customers is inconsistent with satisfying customers' varied (and changing) preferences. *See* Verizon Main Br. at 29-30.

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