Suzan DeBusk Paiva
Assistant General Counsel
Pennsylvania

1717 Arch Street, 17W
Philadelphia, PA 19103

Tel: (215) 466-4755
Fax: (215) 563-2658
Suzan.D.Paiva@Verizon.com

May 11, 2009

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

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

Dear Mr. McNulty:

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

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

Very truly yours,

Suzan D. Paiva

SDP/slb

<u>VIA E-MAIL and UPS DELIVERY</u>
cc: ALJ Susan D. Colwell
Attached Certificate of Service

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of Verizon's 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 11th day of May, 2009.

VIA E-MAIL and UPS DELIVERY

Norman J. Kennard, Esquire
Regina L. Matz, Esquire
Jennifer M. Sultzaberger
Thomas, Long, Niesen & Kennard
212 Locust Street, Suite 500
Harrisburg, PA 17108
Rural Telephone Company Coalition

Bradford M. Stern, Esquire
Rothfelder Stern, L.L.C.
625 Central Avenue
Westfield, NJ 07090
Omnipoint Communications Inc. d/b/a T-Mobile; Omnipoint Communications Inc. d/b/a T-Mobile and Voicestream Pittsburgh LP d/b/a T-Mobile Nextel Communications, Inc.

Christopher M. Arfaa, Esquire
Christopher M. Arfaa, P.C.
150 N. Radnor Chester Road, Suite F-200
Radnor, PA 19087-5245
Cingular Wireless LLC
Cellco Parthership d/b/a Verizon Wireless

Joel Cheskis, Esquire
Barrett Sheridan, Esquire
Christy Appleby, Esquire
Office of Consumer Advocate
555 Walnut Street, 5th Floor
Harrisburg, PA 17101-1923

Steven C. Gray, Esquire
Office of Small Business Advocate
300 North 2nd St, Suite 1102
Harrisburg, PA 17101

Zsuzanna Benedek, Esquire
Embarq Corporation
240 North Third Street, Suite 201
Harrisburg, PA 17101

Joseph R. Stewart, Esquire
Embarq Corporation
50 West Broad Street, Suite 3600
Columbus, OH 43215

Michelle Painter
Painter Law Firm, PLLC
13017 Dunhill Drive
Fairfax, VA 22030
AT&T Communications of PA, LLC, TCG Pittsburgh and TCG New Jersey

John C. Dodge, Esquire
Davis, Wright Tremaine, LLC
1919 Pennsylvania Avenue NW
Suite 200
Washington, DC 20006
Comcast Digital Phone and Comcast
Business Communications, LLC

Pamela C. Polacek, Esquire
Shelby A. Linton-Keddie, Esquire
McNees Wallace & Nurick LLC
P.O. Box 1166
100 Pine Street
Harrisburg, PA 17108-1166
Broadband Cable Association of PA

Renardo L. Hicks, Esquire
Stevens & Lee, P.C.
17 North Second Street
16th Floor
Harrisburg, PA 17101

Benjamin J. Aron
Sprint Nextel Corporation
Mailstop: VARESP0201-208
2001 Edmund Halley Drive
Reston, VA 20191

Suzan D. Paiva
Pennsylvania Bar ID No. 53853
1717 Arch Street, 17 NW
Philadelphia, PA 19103
(215) 466-4755

Attorney for
Verizon Pennsylvania Inc.
Verizon North Inc.
MCImetro Access Transmission Services, LLC
d/b/a Verizon Access Transmission Services

PENNSYLVANIA
PUBLIC UTILITY COMMISSION

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

(Limited Re-opening per Order entered April 24, 2008)

VERIZON'S MAIN BRIEF

Leigh A. Hyer (Atty No. 204714)
Suzan D. Paiva (Atty No. 53853)
Verizon
1717 Arch Street, 17th Floor
Philadelphia, PA 19103
(215) 466-4755

Dated: May 11, 2009

Attorneys for Verizon Pennsylvania Inc., Verizon North Inc. and MCImetro Access Transmission Services, LLC d/b/a Verizon Access Transmission Services

TABLE OF CONTENTS

INTRODUCTION 1

STATEMENT OF THE CASE 4

ARGUMENT 7

I. RETAIL RATE CAP 7

A. Retail Rate Caps In Connection With RLEC Annual Revenue Increases Are Neither Necessary Nor Supported By The Record .. 7

1. Chapter 30 Provides Sufficient Safeguards And No Additional Rate Cap Is Needed 8

2. The Record Does Not Support An $18 Residential Rate Cap 11

a. The Commission Has The Authority To Eliminate Or Increase Any $18 Residential Benchmark 11

b. The "Affordability" Evidence Does Not Support An $18 Rate Cap 12

c. The Comparability" Evidence Does Not Support An $18 Rate Cap 15

3. The Record Does Not Support Any Business Rate Cap ... 19

II. UNIVERSAL SERVICE FUND 21

A. The USF Should Not Be Increased To Accommodate The RLECs' Annual Chapter 30 Revenue Increases 21

1. The RLECs And OCA Propose An Entirely New And Different USF 21

2. The RLEC/OCA Proposal Would Vastly Expand The Size Of The Existing USF 23

3. Using The USF To Fund The RLECs' Revenue Increases Would Harm Consumers And Competition 24

4. Using The USF To Fund The RLECs' Revenue Increases Would Insulate The RLECs From The Disciplining Effect Of The Market, Contrary To The Premise Of Alternative Regulation 26

B. While There Should Be No "Needs" Test For USF Subsdies, The RLECs' Failure Even To Attempt To Show Actual Need Is Grounds To Reject Their Proposal 29

C. The Commission Should Reduce The Current USF Based On The Record Developed Here 33

CONCLUSION 35

TABLE OF AUTHORITIES

2006 Annual Price Stability Index / Service Price Index Filing of Buffalo Valley Telephone Company, No. P-00981428F1000 (Opinion and Order entered December 7, 2007)

2006 Annual Price Stability Index / Service Price Index Filing of Buffalo Valley Telephone Company, No. P-00981428F1000 (Opinion and Order entered July 11, 2007)

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

Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Low-Volume Long Distance Users; Federal-State Joint Board On Universal Service, Sixth Report and Order in CC Docket Nos. 96-262 and 94-1 (FCC)

CALLS Order, Report and Order in CC Docket No. 99-249, Eleventh Report and Order in CC Docket No. 96-45, 15 FCC Rcd 12962 (May 31, 2000)

47 U.S.C. § 254(b)(3)

66 Pa. C.S. § 1301

66 Pa. C.S. §3015(c)(2).

52 Pa. Code § 63.161(3).

INTRODUCTION

Verizon[1] and other Pennsylvania telephone carriers already provide huge revenue support to the rural incumbent local exchange carriers ("RLECs") through the dual subsidy mechanisms of (1) inflated RLEC intrastate access charges and (2) the existing $30 million-per-year state universal service fund ("USF"). While these other telephone companies write the checks, it is the ordinary Pennsylvania consumers who really foot the bill because this enormous revenue flow that is diverted to the RLECs each year distorts the competitive marketplace.

Not only have the RLECs successfully kept this gravy train going for years – holding at bay the promised substantive examination of these forced subsidies – but now they seek to increase exponentially the amount of money they receive from other carriers. Together with the Office of Consumer Advocate ("OCA"), they ask this Commission to create a ***new*** USF, fundamentally different in size, scope, operation and purpose from the current temporary and interim USF, to force other carriers to fund the RLECs' annual inflation-based revenue increase opportunities under alternative regulation with a guaranteed and ever-increasing amount of new revenue each year, instead of requiring the RLECs to raise revenue from their own operations as the Legislature intended. They claim that they are ***entitled*** to take this money from other carriers, even if they do not actually need new subsidies.

Worse yet, the companies most likely to benefit from this scheme are not small "mom and pop" telephone companies at all, but are the mid-tier RLECs, subsidiaries of

---

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

large and sophisticated telecommunications conglomerates such as Embarq, Windstream, Frontier, Consolidated and D&E – which already receive a full 83% of the current USF. Consumers lose all around from this proposal. The contributing companies' customers lose because this enormous expansion and transformation of the USF will hamper the contributing companies' ability to best serve consumers in their own territories, while the RLECs' customers lose because the proposal would suppress competition and innovation in the RLECs' territory. The Commission should reject this indefensible and anti-consumer proposal.

It is evident that what the RLECs really seek is the revenue guarantee of rate-of-return regulation – at the expense of other carriers, including their own competitors – while at the same time reaping all the benefits of alternative regulation, such as freedom from an examination of their profits and finances, full pricing flexibility for competitive services and annual inflation-based revenue increases without regard to costs or need. But the RLECs cannot have it both ways. They have chosen to be governed by alternative regulation, under which regulators do not set rates based on the costs of service and their return is not guaranteed. If an RLEC asserts that it cannot stay in business under alternative regulation without additional external subsidies, then that RLEC should go back to rate-of-return regulation and submit itself to a comprehensive rate case, but it should not be entitled to increase its subsidies from other carriers based on vague claims and generalities.

As part of the RLEC/OCA one-sided USF proposition, they assert that RLEC basic residential rates should be "capped" at $18 and that business rates should be capped at some unspecified level. But their self-serving arguments are not based on any evidence that such caps are truly needed – they are only intended to establish the lowest possible threshold for

the RLECs to begin taking money from other carriers. The record fails to support the need for an $18 residential rate cap, or any business rate cap, particularly when the OCA's own witness conceded that even the most conservative level of "affordability" for residential customers is much higher than $18. Not only does Chapter 30 itself already control the pace of retail rate increases, limiting them by a formula tied to the rate of inflation, but many of the RLECs are not even approaching the $18 level. All of this evidence demonstrates that there is no need for a residential rate cap, and particularly not for one as low as $18. In fact, the RLEC/OCA scheme of dangling the prospect of free USF money to those RLECs that raise their rates to the $18 level will likely encourage some RLECs to increase their rates when they might not otherwise have done so.

Even if the Commission wishes to establish or continue a residential rate affordability benchmark for some purpose, there is no reason that it has to be tied to the RLEC/OCA new USF scheme. If the Commission sets any benchmark, it should make clear that if an RLEC reaches that rate level the RLEC is ***not*** entitled to new USF support. Instead, the benchmark should be considered a "safe harbor" that, once reached, would trigger a more detailed Commission analysis of whether the resulting rates will be just and reasonable to the RLEC's residential customers. Based on the record evidence, this safe harbor must be substantially higher than $18. But regardless of whether any benchmark or safe harbor is set and reached, if an RLEC wishes to collect the additional revenue permitted by its alternative regulation formula, it must find a way to collect that revenue from its own retail customers and not through excessive, anti-competitive subsidies provided by other telephone carriers.

STATEMENT OF THE CASE

The Commission originally opened this investigation on December 20, 2004 to try to decrease the flow of revenue from other carriers to the RLECs by "consider[ing] whether [RLEC] intrastate access charges and intraLATA toll rates . . . should be decreased" and "any and all rate issues and rate changes that should or would result in the event that disbursements from the Pennsylvania Universal Service Fund are reduced and/or eliminated." (12/20/04 Order, Ordering ¶ 1). Over the objections of the RLECs' access customers, including Verizon, this aspect of the investigation has been stayed several times to await developments in the Federal Communications Commission's ("FCC") intercarrier compensation investigation, and in the interim RLECs have continued to charge their excessive switched access rates and also to collect over $30 million each year from the USF.

By order entered April 24, 2008, the Commission granted "in part" a third stay of the investigation, again staying its consideration of reducing RLEC access rates. However, based on developments in a parallel case relating to three of the RLECs – the D&E companies[2] – the Commission determined that certain issues could no longer be deferred and must be addressed immediately.

In particular, the reopening of this portion of the investigation was precipitated by a series of arguments made in connection with the 2006 price change filing by the D&E companies under their Chapter 30 alternative regulation plans, in which the D&E companies argued that they were entitled to collect a portion of their increase to

[2] The three RLEC companies, collectively referred to as "the D&E companies" or "D&E", are Denver & Ephrata Telephone & Telegraph Company ("Denver & Ephrata"), Buffalo Valley Telephone Company ("Buffalo Valley") and Conestoga Telephone & Telegraph Company ("Conestoga").

noncompetitive revenue from the USF. Chapter 30 of the Public Utility Code allows incumbent LECs such as the RLECs to choose to operate under the alternative form of regulation permitted by that statute, instead of under traditional rate-base, rate-of-return regulation. An RLEC that elects alternative regulation must have an alternative regulation plan approved by the Commission. Under alternative regulation, an RLEC's overall revenue from noncompetitive services generally can be increased each year based on the change in the rate of inflation, and this is largely the only way that rates for noncompetitive services may be increased. The alternative regulation plans contain an inflation-based formula that calculates an allowable increase to annual revenue from noncompetitive services, based on the previous year's noncompetitive revenue and the change in the rate of inflation from the prior year. A carrier typically makes a price change filing each year presenting its calculation of the allowed overall revenue increase and detailing the changes to rates for noncompetitive services from which it proposes to secure the additional revenue. Carriers also have the option to bank the revenue opportunity for future use. (VZ St. 1.0 (Price Direct) at 11-12).

Following the Commission's rejection of the D&E companies' attempt to increase their already excessive switched access rates charged to other carriers as the recovery mechanism for this allowable increase to noncompetitive revenue, two of the three D&E companies determined to bank their opportunities. The third company (Denver & Ephrata) argued that implementing the price change opportunity through a retail rate increase would require it to increase its residential rates over $18 and its business rates over what it claimed was a corresponding business rate cap of $23.58. Denver &Ephrata argued that it could not charge end users for any amounts over these levels, but instead

had an absolute right under its alternative regulation plan to be reimbursed for this revenue by the USF. The Commission rejected this argument and D&E and OCA have appealed to the Commonwealth Court, where the case remains pending.[3]

Meanwhile, to address Denver & Ephrata's argument that the Commission had failed to provide the appropriate notice and opportunity to be heard relative to the rate cap and USF arguments, the Commission's April 24, 2008 order reopened this investigation on a limited basis to address two general issues: (1) the existence and potential alteration of any "caps" on RLEC residential and business monthly service rates; and (2) potential increases or decreases in funding provided to RLECs from the USF. The issues to be addressed were detailed in that order and also included whether there should be a "needs based" test for an RLEC to continue to receive state USF distributions or to increase those distributions and any potential anti-competitive effects of allowing USF subsidies funded by other carriers to be used to allow RLECs to avoid retail rate increases and still acquire new revenue to support their own operations. (4/24/08 Order at 24-26).

The RLECs have twisted what started out as an investigation to determine how to ***reduce*** the forced subsidy flow from other telephone carriers to the RLECs into an investigation to entertain the RLECs' arguments in favor of an exponential ***increase*** in those subsidies, without regard to whether those subsidies are actually needed. The Commission should reject this ploy.

---

[3] *Buffalo Valley Tel. Co. v. PUC*, No. 847 C.D. 2008.

ARGUMENT

I. RETAIL RATE CAP

A. Retail Rate Caps In Connection With RLEC Annual Revenue Increases Are Neither Necessary Nor Supported By The Record

The first prong of the RLEC/OCA argument is that the Commission should continue or establish a "rate cap" of $18 for RLEC basic residential rates and an unspecified level for RLEC basic business rates. These rate caps are a vital feature of the subsidy scheme advocated by the RLECs and OCA because they mark the point where the RLECs cease collecting their annual revenue increase opportunities from their own retail end users and begin collecting them from other carriers. But the record here does not support the RLEC/OCA rate cap argument.

First, the record shows that no rate caps are needed in connection with RLEC alternative regulation revenue increases because the built-in safeguards of Chapter 30 and the operations of the competitive market ***already*** operate reasonably to constrain rate increases in this context. Second, the record shows that if any residential rate benchmark is needed at all (which it is not) it must be set at a much higher level that $18 under RLEC/OCA's own principles of "comparability" and "affordability" ***and*** that any such benchmark should not be used as a departure point for subsidy claims against other carriers through the USF because there is no reason to tie it the two issues. Third, these parties did not even attempt to present evidence to support a basic business rate cap – a fatal flaw in their arguments.

1. Chapter 30 Provides Sufficient Safeguards And No Additional Rate Cap Is Needed

This Commission has already recognized that its previous $16 and $18 residential rate caps were established for the limited purpose of controlling rate rebalancing (where access or toll rates reductions are offset by the USF in lieu of retail rate increases) and not for the purpose of providing new RLEC revenue under their Chapter 30 plans.[4] What the RLECs and OCA are proposing here is an entirely ***new*** type of rate cap, to be used for a new and different purpose – to limit the RLECs' exercise of their annual revenue increase opportunities under Chapter 30 and to provide a starting point for other carriers to fund those increases through an expanded USF. But there is no need for a rate cap to constrain the RLECs' exercise of their rate change opportunities. Chapter 30 ***already*** contains its own safeguards to limit the pace and magnitude of annual inflation-based rate increases. Even if under alternative regulation the RLECs are free in theory to raise their residential rates, there are other disciplining factors besides a rate cap that will continue to control RLEC prices.

Chapter 30 contains its own internal safeguard to control the pace of any RLEC rate increases by limiting overall revenue increases through a formula tied to the rate of inflation. Chapter 30 is also designed to allow a carrier to exercise its own discretion to choose which of its noncompetitive service rates to increase – or to choose not to increase rates at all – based on its own assessment of the marketplace. In this manner, Chapter 30 also intends for competitive pressures to control rates. Competition unquestionably exists in the RLECs' territories and is a significant factor in their decisions of how and if to allocate their revenue increase opportunities. (*See, e.g.,* VZ St. 1.0 (Price Direct) Exhibit 5 (interrogatory

---

4 *2006 Annual Price Stability Index / Service Price Index Filing of Buffalo Valley Telephone Company*, No. P-00981428F1000 (Opinion and Order entered December 7, 2007) ("D&E 12/7/02 Order") at 27-32.

responses identifying RLEC competitors); AT&T St. 1.2 (Oyefusi/Nurse Surrebuttal) at 6-7).

The record evidence shows that competitive pressures are ***already*** constraining the RLECs' decisions to increase their rates because some RLECs have chosen to bank their revenue increase opportunities even though the resulting residential rates would still be below the alleged $18 rate cap and thus would otherwise be allowed even under their rate cap theory. (*See* VZ St. 1.0 (Price Direct) at 24; VZ St. 1.2 (Price Surrebuttal) at 17). Because of these safeguards, the record shows that there is no widespread risk of most RLECs approaching or exceeding the $18 level given present rate levels and the previous pattern of RLEC banking decisions. (VZ St. 1.0 (Price Direct) at 23-24; VZ St. 1.1 (Price Rebuttal) at 22-23). As Embarq's witness Mr. Gutshall conceded, "there is no current widespread request by rural ILECs to pierce the $18 cap for basic residential service," (Embarq St. 1.0 (Gutshall Direct) at 6) and "[e]conomic and affordability considerations will dictate the rate levels RLECs can sustain in their markets." (*Id.*).

Even if, notwithstanding these safeguards, a particular RLEC determines to raise its basic retail rates above a level that is of concern to the Commission, the Commission still retains authority to review rate levels on a case-by-case basis and may investigate whether the rate increase is just and reasonable to that carrier's end users under 66 Pa. C.S. § 1301.[5] The answer to that question may be different depending on the individual facts of the particular RLEC's serving area and the economic and competitive circumstances at the time.

---

[5] *2006 Annual Price Stability Index / Service Price Index Filing of Buffalo Valley Telephone Company*, No. P-00981428F1000 (Opinion and Order entered July 11, 2007) ("7/11/07 Order") at 25-27. See also VZ St. 1.1 (Price Rebuttal) Exhibit 1 (PUC Commonwealth Court Brief) at 22-23) (arguing that Commission has authority under 66 Pa. C.S. § 1301 to disallow rate increases under an annual price change filing).

By seeking a rate cap, coupled with an absolute right to USF revenue once the cap is reached, the RLECs are really seeking to protect themselves from the competitive market that Chapter 30 intends to foster and encourage. The RLECs want to use the rate cap as a means to obtain a guaranteed, risk-free, competition-proof stream of subsidies from other companies, including from their own competitors, instead of having to make the decision of what rate increase the market will bear. The RLECs' testimony makes it clear that the RLECs seek to use this rate cap to obtain the benefits of operating under alternative regulation under a freely competitive market while eliminating all of the risks. As Embarq's Mr. Gutshall stated, the RLECs wish to obtain revenue from their competitors and other carriers instead of from the RLECs' own customers because they want to increase revenue "without . . . losing access lines to competitors." (Embarq St. 1.1 (Gutshall Rebuttal) at 6). PTA's Mr. Laffey similarly argues that the Commission should use an $18 rate cap as a trigger for USF subsidies because "raising residential local rates above the current $18 cap" would accelerate line loss to competitors in "very competitive" markets. (PTA St. 1 (Laffey Direct) at 6). In fact, establishing an $18 rate cap, together with the prospect of USF subsidies for carriers that increase their residential rates to that level, may have the unintentional effect of encouraging RLECs to increase their rates when they might not otherwise have done so. This proposal is anti-consumer, anti-competitive and contrary to the very premise of alternative regulation.

The Commission should reject the entire USF and rate cap scheme advanced by the RLECs and the OCA. Instead, if the Commission wishes to establish any residential rate benchmark, it should be set at a higher level than the five-year-old $18 benchmark (for the reasons discussed below) and it should function as a safe harbor rather than an absolute cap.

So long as an RLEC's rates remain below the safe harbor level, any increases are automatically deemed just and reasonable and do not require further scrutiny, but if the RLEC proposes to increase residential rates above the safe harbor level the PUC may conduct a more detailed analysis of whether the resulting rates will be just and reasonable considering the particular facts and circumstances relating to that RLEC and its customers. But the rate cap should not be tied to the RLECs' new USF scheme and ultimately any new revenue the RLEC receives must come from its own end users, not other carriers.

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

a. The Commission Has The Authority To Eliminate Or Increase Any $18 Residential Benchmark

The Commission clearly has the authority in this case to eliminate or increase any cap that might exist.[6] The RLECs and OCA concede that, even under their own theory, the rate cap does not necessarily have to be set at $18, and that the actual dollar value of the rate cap could be higher than $18 if the evidence supported it.[7] In Commonwealth Court briefing both the OCA and certain of the RLECs have conceded that this Commission has the authority to eliminate or increase any residential rate cap that might currently exist.[8]

---

[6] Since the Commission has the authority to eliminate or increase a rate cap based on the record developed here, there is not much point in arguing here whether the previous $18 rate cap established in July of 2003 remains effective or has expired. For the record, however, that rate cap has expired by its own terms on December 31, 2006.

[7] *See* Tr. at 104 (Dr. Loube testifies that "benchmark rises" as Verizon's rates rise); Tr. at 483 (Mr. Laffey concedes that he is "not testifying that the rate cap could never be changed in the future" and that "it would be reasonable for that rate [cap] to be looked at periodically.")

[8] In recent briefing to the Commonwealth Court the OCA conceded that it is "not OCA's position" that the $18 rate cap "must continue in perpetuity," and that instead the rate cap may be "modified by the PUC through the proper legal process" under Section 703(g) of the Public Utility Code." (OCA Commonwealth Court Reply Brief at Dockets 847 CD 2008 and 940 CD 2008, at 6-7 (pertinent portions appended to Verizon St. 1.2 (Price Surrebuttal) as Exhibit 1)). Similarly the three D&E RLECs, on whose behalf Mr. Laffey's is testifying in this investigation, told the Commonwealth Court that it is "not [D&E's] position that the rate caps can never be altered," and instead conceded that "the PUC may revisit the rate cap limitation in an appropriate proceeding" with "notice and opportunity," such as this "pending generic investigation." (D&E Commonwealth Court Reply Brief

The $18 rate cap – which as discussed above was adopted for the completely different purpose of controlling access rate rebalancing and is not even applicable to Chapter 30 rate increases – is five years old, and even when the Commission set that cap, it was the product of a settlement and not any analysis of a reasonable level for basic residential rates. As this Commission itself recently noted "the R-1 $18.00 bench mark was set several years ago by agreement without a comprehensive study of affordability." (D&E 12/7/07 Order at 35). Just accounting for the change in the rate of inflation, $18 in 2003 would be over $21 today. (Verizon St. 1.0 (Price Direct) at 25). But as discussed below, the record shows that a residential affordability level would actually be higher than $21. The RLECs and OCA have not come forward with evidence to support an $18 rate cap for any purpose. If the Commission establishes a cap, it should be higher than $18 and should ***not*** be used to trigger any new RLEC claims from the USF. Rather, it should serve only as a safe harbor to mark the point at which the Commission may engage in a review of rate reasonability. But ultimately, the RLECs should be required either to obtain their revenue opportunities from their own end user rates, or to bank them.

b. The "Affordability" Evidence Does Not Support An $18 Rate Cap

The OCA and RLECs contend that an $18 residential rate cap is needed to preserve the "affordability" of basic residential local service. As Mr. Laffey stated, "[t]he rate cap was set as a means to assure an 'affordable' rate." (PTA St. 1R (Laffey Rebuttal) at 19; *see also* Tr. at 479). He further discusses establishing an "affordability rate," referring to statements in Chapter 30 regarding "affordable" and "reasonably priced" service as support

at Dockets 847 CD 2008 and 940 CD 2008, at 22 (pertinent portions appended to Verizon St. 1.2 (Price Surrebuttal) as Exhibit 2)).

for an $18 cap. (PTA St. 1R (Laffey Rebuttal) at 15-16, 21; *see also* Embarq St. 1.1 (Gutshall Rebuttal) at 2).

If, as the RLECs concede, the primary justification for a cap is to limit regulated residential basic service rates to an allegedly "affordable" level, then the record evidence does not support an $18 rate cap to ensure "affordability." The only witness to present evidence of "affordability" for basic residential rates in Pennsylvania was OCA's Mr. Colton, who quickly admitted that even under his most conservative analysis the "affordability" level in Pennsylvania is $32 – and as Mr. Price demonstrated it is actually much higher. (Tr. at 132; OCA St. 2 (Colton Direct) at Schedule RDC-5; VZ St. 1.1 (Price Rebuttal) at 24). Including taxes and fees the $18 basic rate totals about $27, and Mr. Colton conceded that every single one of the RLECs "currently [has] basic service rates below the affordability [level]," with the highest RLEC rates still about $5 below and the lowest RLEC rates being a full $15 below the ***most conservative*** affordability level of $32.[9]

The record also showed that $32 is actually too conservative, and that if any level of residential "affordability" is used in the Commission's analysis, it should be higher. Mr. Colton noted that the $32 affordability level he presumed was generated by making the very conservative assumption that the average customer would spend only 0.75% of his income on basic local service, an assumption that Mr. Price explained was not reasonable in light of the facts known about consumer spending.[10] Mr. Colton admitted that if that assumption

---

9 Tr. at 132, 134; *see also* OCA St. 2 at Schedule RDC-4 (showing that, with taxes and fees the RLEC basic residential rates range from a low of $16.72 per month to a high of $27.10 per month, all well below $32); VZ St. 1.1 (Price Rebuttal) at 24

10 Mr. Colton's analysis is conservative in assuming that customers can "afford" to spend just 0.75% of a family's income on basic local telephone service. Mr. Price demonstrated that according to the FCC's own data, households in the lowest quintile of household income in 2006 spent on average 3.11% of their total household expenditures on telephone services and that the average household expenditure for telephone services for rural households was 2.62% of total household expenditures. (VZ St. 1.1 (Price

were adjusted upward only slightly, to 1% of income, the resulting affordability level would be almost $43 – far higher than even the highest RLEC rate. (Tr. 132-133).

Further, as Mr. Colton explained, regardless of where RLEC rates are set, those customers eligible for Lifeline service – the ones for whom the Commission would be expected to have the greatest "affordability" concern – will pay more than ***$10 less*** than the ordinary customer for basic residential service. For example, where the average RLEC customer would pay about $27 for basic local service under an $18 basic rate (when fees and taxes are included), a Lifeline customer would be entitled to various credits and would pay only $15.25 for the same service. (Tr. at 135). Thus, there is no need to assume the most conservative possible affordability level, as Mr. Colton has done, because those Lifeline customers for whom affordability would be of greatest concern are subject to additional protections.

Mr. Colton's testimony also shows that the affordability level can be expected to increase over time. From 2004 to 2008 Mr. Colton's calculations show his affordability level increasing by $2 to $4. (OCA St. 2 (Colton Direct) at Schedule RDC-5). Thus, if one assumed that $18 was an "affordable" level for RLEC basic local rates in 2003 (although Mr. Colton's data suggests that it was low even at that time), Mr. Colton's data indicates that this level could increase to $20 to $22 dollars in 2008 based on the increase in the median income and other indicators of "affordability" relied upon by Mr. Colton. (VZ St. 1.1 (Price Direct) at 25.)

Rebuttal) at 25-26 and Exhibit 3). If only half of the average rural household expenditure were for basic local service it would still be 1.3% of total expenditures, or $43.25 per month. This data suggests that Mr. Colton's affordability estimate is conservative and too low. (*Id.* at 25-26).

Because the concept of "affordability" so clearly does ***not*** support an $18 rate cap, Mr. Colton (the only witness on "affordability) made clear that he was not testifying "that there should or should not be" a retail rate cap or "whether the $18 should be $18 or $16 or some other number," but rather his testimony was "limited to the affordability analysis." (Tr. at 138-139). Rather than supporting an $18 rate cap, Mr. Colton's testimony demonstrates that this level is too low.

The other parties' own evidence thus overwhelmingly demonstrates that the RLECs' existing rates are nowhere near levels that would present an "affordability" concern, and thus there is no reason to interfere with the operation of their annual price change opportunities. Even Mr. Colton's conservative affordability analysis shows that RLEC residential rates could increase substantially higher than $18 and still remain "affordable." (VZ St. 1.1 (Price Rebuttal) at 24). Under Mr. Colton's data, there would appear to be no danger of RLEC rates becoming unaffordable in the near future if the RLECs are permitted to let their alternative regulation revenue increase opportunities take their natural course with small, inflation-based rate increases each year at the carrier's option, constrained by the inflation-based Chapter 30 formula and the discipline of the competitive market. Accordingly, there is no need for a residential rate cap at any level, and certainly no justification to cap those rates at $18.

c. The Comparability" Evidence Does Not Support An $18 Rate Cap

Because the only record evidence regarding "affordability" does not come close to supporting an $18 rate cap, and shows that customers can reasonably afford to pay rates well above $18, OCA and the RLECs attempt to skew the number downward by arguing that "comparability" to urban rates (primarily Verizon's rates) must also be considered. In other

words, the RLECs argue that even if customers' "affordability" level is above $18, the RLEC rates should be kept "comparable" with Verizon's basic regulated rates – which themselves have been artificially depressed due to regulation. The RLEC proposal would thus require Verizon and other carriers to subsidize the RLECs rather than requiring the RLECs to look to their own customers for revenue increases.

The OCA and RLECs based this argument on 47 U.S.C. § 254(b)(3), which lists as one of the governing "principles" for the FCC and the Federal-State Joint Board on Universal Service that "[c]onsumers in all regions of the Nation, including low-income consumers and those in rural, insular, and high cost areas, should have access to telecommunications . . . at rates that are reasonably comparable to rates charged for similar services in urban areas." 47 U.S.C. § 254(b)(3). (*See* PTA St. 1 (Laffey Direct) at 9-10). But the Public Utility Code does not mandate that RLEC rates must be "reasonably comparable" to any other carrier's rates, and Section 254(b)(3) is not a mandate to ***state*** commissions regarding intrastate rates. Accordingly, the RLECs' and OCA's comparability analysis is irrelevant.

But even if there were some reasonable basis to limit the RLECs' rates to a level "reasonably comparable" to some other carrier's rates – notwithstanding that the RLECs and OCA concede that customers could afford to pay higher rates – it is unreasonable to use Verizon's basic rates as the standard upon which to limit the RLECs from increasing their own residential rates. Verizon's own rates have been kept artificially low by regulation and there has been no determination either that Verizon's current regulated basic residential local service rates define the level of "affordability" today, or that customers could not afford to pay rates higher than Verizon's residential rates. In fact, due to regulation,

Verizon's basic residential local service rates have remained relatively unchanged for many years, and were not increased in step with the rate of inflation until very recently. With the enactment of the original Chapter 30 in 1993 until the modification of Verizon's alternative regulation plans to comply with the new Chapter 30 in 2004, Verizon PA operated with a large "inflation offset" in its price change formula that had the effect of precluding annual noncompetitive services rate increases. As discussed in the *Global Order*, Verizon PA's rates also were capped for a time.[11] Verizon's ability to increase these rates is still limited by the inflation-based terms of its alternative regulation plan and the provisions of Chapter 30. (VZ St. 1.1 (Price Rebuttal) 32-33).

However, even if Verizon's rates were relevant, the parties' "comparability" calculations based on Verizon's urban rates are flawed. (VZ St. 1.1 (Price Rebuttal) at 32-35). For example, Mr. Laffey initially assumed that "reasonably comparable" could only mean "equal to," or "effectively equal to" Verizon's rates. (PTA St. 1R (Laffey Rebuttal) at 22). In his surrebuttal he conceded that there must be some margin within Verizon's rates that would still be "reasonably comparable," and arbitrarily asserted a 115% margin. (PTA St. 1SR (Laffey Surrebuttal) at 4; Tr. at 484). Dr. Loube acknowledged from the outset that "reasonably comparable" would include some margin above Verizon rates, and asserted a margin of 120%. But the "margins" asserted by Mr. Laffey (115%) and Dr. Loube (120%) are completely arbitrary, and even Dr. Loube admits that other states that tie rates to other carrier rates in the state look to higher percentages, such as 130% in Wyoming and 150% in California. (OCA St. 1 (Loube Direct) at 11-12; VZ St. 1.1 (Price Rebuttal) at 34-35).

---

[11] *Joint Petition of Nextlink Pa., Inc.*, Docket Nos. P-00991648; P-00991649, 93 Pa. P.U.C. 172 (1999) (*"Global Order"*), slip op. at 185 (Verizon PA rates for "protected" services capped through December 31, 2003).

Therefore, even if the Commission were to look to some "margin" above Verizon's urban rates, the margins argued by Dr. Loube and Mr. Laffey are too low.

Even if it were valid to look to comparability with Verizon's own artificially depressed regulated rates, correcting for the flaws in both witnesses' recommendations would lead to a much higher "reasonably comparable" level than either of them advocates. For example, using a straight average of Verizon's $16.06 Density Cell 1 rate and $16.36 Density Cell 2 rate, which went into effect on March 1, the "urban" rate would be $16.21.[12] Using a 150% comparability range would yield a "reasonably comparable" rate of $24.32 – a level that would be expected to increase each year with Verizon's exercise of its own price change opportunities. (*See* VZ St. 1.1 (Price Rebuttal) at 35). Even using Dr. Loube's 120% comparability factor, 120% of $16.21 is $19.45.[13] As Mr. Laffey conceded, considering the Verizon urban Density Cell 1 and 2 rates that went into effect on March 1 of 2009, even the application of his rock-bottom 115% margin would result in rates higher than $18, and that level can be expected to increase each year as Verizon exercises its own price change opportunities.[14]

---

12 This is the same analysis Mr. Laffey performed with the earlier period rates. (PTA St.1SR (Laffey Surrebuttal) at 4; Tr. at 487 (Laffey) (conceding that he did not use the Verizon rates that took effect March 1, 2009, and if he had then under his own calculation "the result would be higher than $18")).

13 Possibly realizing that a comparison to Verizon's urban Density Cells would not yield the result he wanted for his own comparability analysis, OCA's Dr. Loube significantly understates the Verizon rates to which he compares the proposed $18 cap by calculating an alleged weighted average statewide residential rate that is lower than the rates Verizon charges in urban areas, weighted downward by Verizon's own lower rural rates. But the very federal statute upon which Dr. Loube relies states that rural rates should be "reasonably comparable to rates charged for similar services in ***urban*** areas." (OCA St. 1 (Loube Direct) at 8) (emphasis added). Therefore, even Mr. Laffey had to recognize that Dr. Loube's approach "deviates from the statute by using average statewide rates, rather than comparing urban and rural rates specifically." (PTA St. 1R (Laffey Rebuttal) at 22).

14 Mr. Laffey also looks to a comparison to national average rates as reported by the FCC. (PTA St. 1 (Laffey Direct) at 9). The most recently reported monthly average from 2007 was $15.62, but as Mr. Price explained, the FCC itself has acknowledged that relying on a national average is not perfect and uses a very wide range of rates that can be considered "comparable" to urban rates nationwide, the upper end of that which is as high as $36.52. (VZ St. 1.1 (Price Rebuttal) Exhibit 3). Moreover, the FCC average is merely an average of existing rates whose levels may themselves have been kept artificially

Accordingly, even if the principle of comparability to Verizon's rates were relevant – which it is not – a "reasonably comparable" rate to Verizon's urban Pennsylvania rates is higher than $18.

3. The Record Does Not Support Any Business Rate Cap

Even if the record supported imposing a rate cap that would restrict the RLECs from increasing basic ***residential*** rates to implement their annual price change opportunities – which it does not for the reasons discussed above – the RLECs and OCA did not even attempt to submit record evidence to support a corresponding cap on basic ***business*** rates. This is a fatal flaw in their arguments for USF support above a purported residential rate cap because even if a particular RLEC reached a point where it was restricted from increasing basic ***residential*** rates due to a rate cap, without a corresponding ***business*** rate cap, that RLEC could still increase its basic business rates to implement its revenue increase opportunity, and possibly raise other non-competitive service rates as well. PTA's Mr. Laffey conceded this fact at the hearing, noting that "if there was no business benchmark rate," then "the compan[ies] could raise . . . business rate[s] in [their] price change opportunit[ies]" and that "[i]f you then take away the business cap there's no ceiling involved there for the Fund to compensate." (Tr. at 499-500 (Laffey)).

The record simply does not contain the evidence to support imposing a business rate cap at all, much less to restrict the RLECs from increasing their business rates to implement their annual price filings and requiring other carriers – including their direct competitors – to reimburse them to allow them to ***avoid*** raising their business rates. The OCA did not even

low by regulatory policies that pre-date today's competitive market, leaving Mr. Laffey with the same circular argument that he makes when comparing to Verizon's rates – that the RLECs' Pennsylvania's rates should not be increased in the future because other carriers' rates have been kept artificially low in the past. (VZ St. 1.1 (Price Rebuttal) at 36).

advocate a business rate cap. The RLECs vaguely asserted that the "corresponding business rate cap limitation[] should not be increased,"[15] but the RLECs do not even agree among themselves as to what the alleged "current" cap is.[16] No party has articulated how this alleged business rate cap should be calculated, aside from Mr. Laffey's vague assertion that the business cap is different for each RLEC based on some unspecified "proportion" to company's residential rates from ten year ago, at the time of the *Global Order*. (PTA St. 1R (Laffey Rebuttal) at 3; VZ St. 1.2 (Price Surrebuttal) at 24-25).

Further, no party even attempted to support these rate levels – or any particular business rate level – on a substantive basis as a reasonable "cap" on RLEC business rates. In fact, Mr. Laffey's own testimony concedes that the national average single line business rate was $36.59 in 2007 (a figure that itself is likely higher today).[17] This 2007 national average is ***$10 higher than*** Embarq's alleged cap of $26.23 and ***$13 higher than*** D&E's alleged cap $23.58. All of the RLECs' business rates for which Verizon had information in discovery are substantially lower than this national average. (VZ St. 1.0 (Price Direct) Table 1).

It would be an absurd result to require other carriers, including direct competitors, to reimburse the RLECs to allow them to avoid increasing business rates that are presently about $10 or more below the national average. Given that the RLEC business rates are so far below those of other carriers, there is no need even to consider a "cap" on business rates. The RLECs should be permitted to make their annual inflation-based rate increases to

---

15 PTA St. 1 (Laffey Direct) at 2; see also Embarq St. 1.0 (Gutshall Direct) at 3.

16 VZ St. 1.1 (Price Rebuttal) at 39-40 (noting that Embarq has asserted that the cap is $26.23 while D&E has asserted that the cap is $23.58, but that several RLECs charge business rates higher than the alleged cap levels asserted by Embarq and D&E).

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

business rates in due course as contemplated by Chapter 30 and their alternative regulation plans. The Commission must look to maximizing the RLECs' ability to raise revenue from their own end users through noncompetitive services rate increases rather than looking to impose a system of revenue subsidies from other carriers. There is no justification – and no supporting evidence – to require other carriers, some of whom compete directly with the RLECs for business customers, to pay the RLECs to help them avoid raising their basic business rates.

II. UNIVERSAL SERVICE FUND

A. The USF Should Not Be Increased To Accommodate The RLECs' Annual Chapter 30 Revenue Increases

1. The RLECs And OCA Propose An Entirely New And Different USF

The OCA and the RLECs are asking for something very different from the USF that was adopted by the 1999 *Global Order* and maintained through the Commission's USF regulations. The current USF provides the RLECs with approximately $30 million in revenue each year, tied to specific access and toll reductions from the 1999/2000 timeframe. By contrast, under the plan proposed by the OCA and the RLECs, the USF would increase unpredictably every year, based on the RLECs' calculated revenue increase opportunities under their alternative regulation plans, and the USF would provide a ***new*** stream of subsidy revenues to the RLECs each year.

The Commission did not establish or intend the current USF as a means to generate additional revenues for the RLECs. It was simply a temporary mechanism adopted 10 years ago to replace the revenue from a discrete set of access and toll rate reductions to help the RLECs transition to a competitive market – funded by the carriers that stood to benefit from

those access and toll rate reductions. (*See* Verizon St. 1.0 (Price Direct) at 8-9). According to the settlement adopted by the *Global Order* that created the USF, "[a]ll revenues received from the Fund, after the deduction therefrom of any contribution made by a Fund Recipient to the Fund, ***shall*** be used to rebalance, on a revenue neutral basis, the rates/revenues derived from access and/or other services according to the rules set forth herein."[18] The Commission's USF regulations also recognize the limited scope and purpose of the fund. The regulations do not provide for expansion of the USF or for a claim for new subsidies to fund the RLECs' alternative regulation revenue increases. To the contrary, the stated "purpose of the Fund is to maintain the affordability of local service rates for end user customers while allowing rural telephone companies to reduce access charges and intraLATA toll rates, on a revenue-neutral basis, thereby encouraging greater competition." 52 Pa. Code § 63.161(3). This Commission itself recently recognized that "the request to recover the amount above the benchmark/rate caps for residence and business customers from the PaUSF is contrary to the intent of the PA USF" and "the PaUSF was not intended to be a permanent arrangement whereby ILECs could draw for compensation for revenue shortfalls." (D&E 12/7/07 Order at 28, 33).

The OCA and RLECs are asking the Commission to create a new and entirely different USF, but the Commission should not do so, for the reasons discussed below.

---

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

2. The RLEC/OCA Proposal Would Vastly Expand The Size Of The Existing USF

As Mr. Price explained – and the RLECs and OCA tellingly did not deny – the RLEC/OCA plan would set in motion a dangerous snowball effect through which the current $30 million USF could quickly expand to double or even triple its size, or more. (VZ St. 1.1 (Price Rebuttal) at 5-7). For example, ten years down the road a single RLEC generating a constant new $2 million revenue increase opportunity each year for which it claims against the USF would be receiving $20 million annually from the fund by year 10, turning the $30 million fund into a $50 million fund – without even accounting for the impact of other carriers' claims. There are over 30 RLECs, and if most or all of them began exercising the opportunity to fund their revenue increases through the USF as the RLECs and OCA propose, there is likely to be much more than $2 million in annual increases to the fund, but rather the size of the USF will increase exponentially. (*Id.*) Indeed, with the prospect of no-risk money available through this RLEC/OCA USF, the RLECs will have a powerful incentive to raise their rates to the cap levels in order to begin claiming this free money.

The potential magnitude of this snowball effect can be seen by reviewing Embarq's testimony on this issue. Embarq goes so far as to contend that not only should the RLECs be able to fund future revenue increase opportunities through the USF, but the RLECs should also be permitted to "recover" their "unexpired banked revenues" from the state USF. (Embarq St. 1.0 (Gutshall Direct) at 22; *see also* OCA St. 1 (Loube Direct) at 28-29). According to Mr. Gutshall, Embarq has nearly $9 million of unused revenue increase opportunities in its bank. (Embarq St. 1.0 (Gutshall Direct) at 18; Tr. at 257). If Embarq were to make a $9 million claim against the USF now, that claim alone would increase the

size of the current fund by almost a third in the first year. If Embarq were to continue to generate new revenue opportunities each year at the same rate, its USF claim would double to $18 million, then triple to $27 million, and so on, soon dwarfing the present size of the fund in payments to Embarq alone, without considering other carriers' potential claims. (VZ St. 1.1 (Price Rebuttal) at 7).[19] This unchecked and perverse growth in the USF should not be allowed.

3. Using The USF To Fund The RLECs' Revenue Increases Would Harm Consumers And Competition

Consumers will lose all around under the new USF proposed by the RLECs and the OCA. Because companies like Verizon, Comcast, AT&T and the others that pay into the USF would be diverting more and more revenue each year to subsidize the RLECs (potentially an exponential increase, as discussed above), their customers would be denied the benefits of revenue that otherwise could have been used to improve the companies' products, services, or networks, or even to reduce rates. Those companies might even be required to increase some rates in order to carry on their everyday operations and meet their ever-increasing USF burden – particularly if the USF snowballs to tens or hundreds of millions of dollars. Because the USF contributions are calculated based on the carriers' intrastate revenue, moreover, telecommunications companies that might otherwise have chosen to invest in Pennsylvania could choose to take their business elsewhere, particularly as the USF burden becomes higher and higher as a percentage of revenue, leaving Pennsylvanians with fewer competitive options. (VZ St. 1.1 (Price Rebuttal) at 10-11).

---

[19] For example, Windstream has nearly $7.5 million in its "bank," (PTA St. 1.0 (Laffey Direct) Exhibit JJL-7), although it has not yet reached the $18 rate level. Mr. Laffey's Exhibit JJL-7 shows that the PTA RLECs have collectively banked at least $13.5 million, beyond Embarq's $9 million.

Customers in the RLEC territory will also suffer. Although they will have access to $18 basic service rates, their opportunities for competitive alternatives will be diminished over time, because any carriers that wish to come in and compete with the RLEC will have to compete with heavily subsidized operations and either may choose not to compete at all or may not compete as effectively.[20] These RLEC customers might also be deprived of service, product and network innovation by the RLEC itself, because an RLEC that is guaranteed a constant, ever-increasing and risk-free stream of revenue from a source other than its customers, and also faces a diminished competitive threat, will naturally have less incentive or need to deploy innovative products and services to retain and attract customers. (VZ St. 1.1 (Price Rebuttal) at 10-11).

The Commission should not encourage the RLECs to rely on anticompetitive business plans that depend more on generating revenues from other carriers – and their customers – than from their own end users. As the FCC has observed, economically efficient competition and the consumer benefits it yields cannot be achieved as long as carriers seek to recover a disproportionate share of their costs from other carriers, rather than from their own end users.[21] Where the RLECs are able to obtain additional subsidies, competition is discouraged and competitors disadvantaged because the competitors must operate without those subsidies, and will be required – directly or indirectly – to fund those

[20] This anti-competitive effect is exactly the opposite of the goal the PUC wished to achieve when it set out to reform RLEC access rates and created the original USF. *See, e.g.,* 52 Pa. Code § 63.161(3) (purpose of the PUC's USF regulations is to "encourage[e] greater competition.")

[21] *See, e.g., Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Low-Volume Long Distance Users; Federal-State Joint Board On Universal Service*, Sixth Report and Order in CC Docket Nos. 96-262 and 94-1 (*CLEC Rate Cap Order*); Report and Order in CC Docket No. 99-249, Eleventh Report and Order in CC Docket No. 96-45, 15 FCC Rcd 12962 (May 31, 2000) ("*CALLS Order*").

subsidies through their own USF assessments. This is of particular concern in the territories of the mid-tier RLECs, where there is decisive competitive presence.[22]

4. Using The USF To Fund The RLECs' Revenue Increases Would Insulate The RLECs From The Disciplining Effect Of The Market, Contrary To The Premise Of Alternative Regulation

In establishing Chapter 30 as the alternative regulation mechanism, the Legislature did not include a provision requiring other carriers to fund the RLECs' annual revenue increases, and if the Commission were to do so here it would undermine the alternative regulatory scheme established by the Legislature. The Legislature presumed that any revenue increases permitted under the inflation-based plan formula would be secured through "rate increase[s]." 66 Pa. C.S. §3015(c)(2). With their USF proposal, the RLECs and OCA would divorce the RLECs' annual exercise of their revenue increase opportunities from the disciplining effects of the market intended by the Legislature.

Specifically, when the RLECs must secure additional revenue through increasing end user rates, as they must now, the market disciplines their actions in at least two ways. First, the RLECs may choose not to increase their rates, even though they have the "right" under their plans to increase noncompetitive services revenue. As an example, some of the RLECs presently have banked revenue even though they could still increase their basic residential rates. (VZ St. 1.0 (Price Direct) at 24; VZ St. 1.1 (Price Rebuttal) at 8; Compare Price Direct Table 1 to Laffey Direct Exhibit JJL-7). The RLECs may view passing up on the rate increases as a better choice in the long run, increasing the chances of keeping those customers on their own networks where the RLEC has the opportunity also to sell them other services. Second, even if the RLECs do choose to increase basic service rates, there is

---

22 *See* VZ St. 1.0 (Price Direct) Exhibit 5 (PTA and Embarq Response to Verizon I-4).

no guarantee that they will secure the same revenue each year from the initial rate increase because Chapter 30 provides only a noncompetitive services revenue increase ***opportunity***, not a guarantee.

Taking the hypothetical RLEC example discussed above, if instead of claiming $2 million from the USF this RLEC implemented basic service rate increases to secure $2 million in new revenue, depending on its line count assumptions, it ***may*** secure something close to that amount in the first year (and, alternatively, may not if, for example, its lines decrease to competition). But if we assume that the hypothetical RLEC is experiencing line losses consistent with the overall trend described by Mr. Laffey (PTA St. 1 (Laffey Direct) at 7), then the number of lines paying the increased rates would decrease over time by approximately 5% each year. This RLEC would thus lose not only approximately 5% per year of its original $2 million per year revenue increase, but it would also lose all of the noncompetitive services revenue that had been paid by the lost lines. Looking ten years out at the impact of that initial year's increase, assuming 5% line loss each year, the original $2 million projected to be secured through those retail rate increases would be cut nearly in half. By contrast, with the RLEC/OCA USF proposal, this hypothetical RLEC would still be recovering $2 million per year ten years out because the RLECs are guaranteed a revenue stream that stays constant each year regardless of line loss – revenue supplied by unwilling payers that do not have a choice to terminate their service and stop paying. Thus, the RLEC/OCA proposal would have the effect of insulating the RLEC from the operations of the competitive market and diminishing the RLEC's incentives to take actions to keep its retail customers. (VZ St. 1.1 (Price Rebuttal) at 6).

Instead, the RLECs' end users, who are the direct beneficiaries of any investment and network deployment enabled by the increase, should provide the new revenue through rates.[23] There is no reasonable basis to force other carriers, some of whom may also be attempting to compete with the RLECs in their own territory, to fund the RLECs' revenue increases. Doing so would be anti-competitive and harmful to consumers.

It is evident that what the RLECs really seek is to enjoy the revenue guarantees of rate-of-return regulation, while at the same time reaping all the benefits of alternative regulation, such as freedom from an examination of their profits and finances, full pricing flexibility for competitive services and annual inflation-based revenue increases without regard to costs or need. The Commission should not permit the RLECs to have their cake and eat it too. The RLECs are the only beneficiaries of their scheme to create an ever-increasing, one-way flow of millions of dollars each year from the customers of other telephone carriers to the RLECs. This distortion of the competitive marketplace and tortured application of alternative regulation will hurt Pennsylvania consumers and will do nothing but protect the RLECs from competition and the discipline of the market. The RLECs failed to provide any reason why the Commission should guarantee them this revenue stream funded by other carriers to the detriment of consumers.

The RLECs have chosen to be governed by alternative regulation, under which their return is not guaranteed. If an RLEC asserts that it cannot stay in business under alternative

---

[23] When end user rates are increased based upon the rate of inflation, these customers are simply experiencing a cost of living increase to the price of services they have voluntarily chosen to purchase and for which they are receiving a value. Moreover, if one credits Dr. Loube's theory that the new revenue is being used to fund broadband deployment (OCA St. 1 (Loube Direct) at 30-31), then the customers may be receiving additional value associated with higher RLEC rates by gaining access to a better network and enhanced services. The carriers forced to contribute to the USF (and their own end-users, who ultimately foot the bill, one way or another), are by contrast simply paying more without making a voluntary choice and without receiving any additional value.

regulation without additional external subsidies, then that RLEC should return to rate-of-return regulation and submit itself to a rate case, but it should not be entitled to increase its subsidies from other carriers based on vague claims and generalities. Mr. Laffey contends that the RLECs have "eschewed the safety net provided by rate of return regulation." (PTA St. 1R (Laffey Rebuttal) at 58). To the contrary, by asking the Commission to require other carriers and their customers to provide the RLECs with an ever-increasing and guaranteed stream of revenue to replace the revenue from their annual Chapter 30 retail rate increases, the RLECs are requesting the ultimate safety net. The Commission should not provide it.

B. While There Should Be No "Needs" Test For USF Subsdies, The RLECs' Failure Even To Attempt To Show Actual Need Is Grounds To Reject Their Proposal

One of the Commission's questions is whether there should be a "needs-based" test for an RLEC to collect subsidies from the state USF for purposes of exercising its annual revenue increase opportunity under alternative regulation. (4/24/08 Order at 23). The Commission should not establish a "needs based" test for this purpose because the Commission should not require other carriers to fund the RLECs annual revenue increases under ***any*** circumstances. Even if a particular RLEC were to come forward and demonstrate that its current operating revenues are not sufficient to meet its operating requirements, it makes no sense from a policy perspective to create a new "passthrough mechanism" that forces "an exchange of revenue between telephone companies"[24] to prop up a failing RLEC business plan. If an RLEC claims that it cannot meet its obligation to provide adequate service under alternative regulation, then the remedy should not be to force other telephone carriers to subsidize that RLEC, with all of the attendant consumer and competitive harms

---

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

discussed above. The only alternative in such an instance should be a return to rate-base, rate-of-return regulation and a comprehensive rate case to establish reasonable end-user rates for that company – in which case the need to fund annual inflation-based revenue increases would no longer be an issue for that company.

But none of the RLECs have alleged or proven a need for increased subsidies – a fact that the Commission should find significant because it shows that there is no real regulatory "problem" that needs a solution here. Not only would it be legally unsupported and bad policy to create the new fund the RLECs recommend, but also the RLECs do not even try to demonstrate any need for a large cash infusion from other telephone carriers. No RLEC has asserted that it cannot meet its operating needs and adequately serve its customers under its current rates and revenue opportunities. One can only presume that the reason the RLECs did not attempt to demonstrate an actual – as opposed to an unproven hypothetical – need for additional cash from the USF is because they could not do so.

Instead, they argue that the RLECs' financial condition is irrelevant to the claim for increased funding. Dr. Loube for OCA concedes that he did not examine and does not know whether the RLECs could meet their operating obligations without this additional USF support. (Tr. at 105-06, 110-111). According to OCA, the RLECs are "not required to prove that they need the funds to meet [their operating] obligations." (Tr. at 112). Similarly, Mr. Laffey conceded that he did not "study the revenues or the costs of any of the individual PTA companies" on whose behalf he testified and that he "did not form any conclusion as to whether" any particular RLEC's "overall costs exceed their overall revenues for Pennsylvania regulated services." (Tr. at 477-478).

Apparently recognizing that their failure to demonstrate need could undercut their credibility, the RLECs in rebuttal attempted to claim that they hypothetically need these subsidies because their costs are too high and that they cannot serve customers without subsidies – but they put forth no evidence to substantiate their claims. Mr. Laffey argues that the RLECs "provide service in areas of the state where access line density is generally very low," and that the Commission should presume – without considering the "overall size" and "corporate affiliation" of the RLEC – that these carriers require USF subsidies above current levels to operate in these rural areas. (PTA St. 1R (Laffey Rebuttal) at 52). Embarq's Mr. Lindsey similarly argues that "[i]n areas of low customer density, revenues from existing customers in those areas will not cover costs due to affordability and competitive pressures." (Embarq St. 2.0 (Lindsey Rebuttal) at 8-9). Mr. Lindsey even argues that it would be "unfair" to consider "financial measures" to determine whether to require other carriers to fund a particular RLEC's annual revenue increases, and that the PUC should just presume that the absence of these new, additional subsidies "would cause great financial harm to mid-size rural carriers and impact their ability to continue to serve and invest." (*Id.* at 9-10). But Mr. Laffey conceded that his entire testimony regarding the need for subsidies for purportedly high cost RLEC exchanges was ***purely hypothetical*** and that he has "no actual costs or actual revenue figures" to back up these statements. (Tr. at 493-494). Further, AT&T's witnesses presented evidence showing that the RLECs' unsupported assertions about their hypothetically higher service costs are not supported by the facts. (*See* AT&T St. 1.2 (Panel Rebuttal) at 21).

Simply because the RLECs serve rural territories does not establish that they cannot serve their customers adequately without increased subsidies from other carriers. To date,

the RLECs have provided service to their customers without the additional subsidies they now seek. They have presented no evidence demonstrating that they are in jeopardy of not being able to continue providing adequate service without a new infusion of cash from the USF. Indeed, as Mr. Gutshall discussed at the hearing, Embarq represented to this Commission to secure approval of its spin-off from Sprint that it would "continue to have the financial capability to invest in its network, generate sufficient cash to pay all expenses and pay a dividend to its shareholders," even though in the same settlement it had agreed to forego several years of its alternative regulation revenue increase, resulting in a voluntary abandonment (or at least substantial postponement) of almost $9 million under its plan. (Tr. at 269-70; VZ Cross Ex. 1 at 10). Also, the RLECs already receive federal USF support for serving high-cost areas, and they have presented no evidence demonstrating that this support is insufficient to allow them to serve their customers adequately.

That the RLECs made no attempt to claim need – and the reasonable inference that there is no actual need – underscores the absurdity of the RLECs' position that the Commission should force other carriers to divert substantial and ever-increasing streams of revenue to their able competitors, the RLECs. Given that the RLECs have not even attempted to offer a meaningful justification for their request to dramatically expand their USF fund, the only conclusion that can be reached is that these carriers are able to meet their current operating needs and serve their customers without additional revenue provided by other carriers. Of course, Verizon is not advocating that a "needs-based" test should be used to increase USF subsidies for an RLEC that legitimately cannot meet its operating needs under alternative regulation; in such a circumstantce, a return to rate-of-return regulation is the appropriate remedy. However, the Commission may rely on the fact that

the RLECs did not even attempt to prove need as a basis to reject their USF proposal. If they do not need the revenue, then they have not even scratched the surface to meet their burden of justifying the establishment of a new and costly USF.

C. The Commission Should Reduce The Current USF Based On The Record Developed Here

Not only should the Commission reject the RLECs' arguments to expand and fundamentally alter the USF as a means to fund the RLECs' annual alternative regulation revenue increases, but also it should plan to reduce and ultimately eliminate the current USF.[25] At the very least the Commission should seriously examine why it is still necessary to require other carriers to provide millions of dollars in annual subsidies to the mid-tier RLECs such as Windstream, Embarq, Consolidated, Frontier and D&E, even if it does not immediately terminate the USF for the smaller RLECs.[26]

Mr. Laffey's data demonstrates the fundamental unfairness of continuing to allow the RLECs to collect the USF subsidy amounts established by the *Global Order* to replace the revenue lost through access and toll reductions made nearly 10 years ago. Mr. Laffey contends that on average the RLECs have experienced a 20% line loss since the *Global Order*. (PTA St. 1 (Laffey Direct) at 7). In absolute terms, then, the RLECs are actually profiting from the current USF because, if they had rebalanced the revenue to local service rates or left it in access and toll rates back in 1999-2000, they would not have been guaranteed a constant annual stream of revenue of $30 million a year for nearly 10 years, as they have been with the USF. If the RLECs had rebalanced their access and toll reductions

---

[25] *See* October 9, 2008 Order on Reconsideration ("we did not intend for there to be a preclusion of evidence that funding for the PAUSF should decrease.")

[26] *See* VZ St. 1.0 (Price Direct) at 3-22 (detailing the size, scope and corporate affiliations of the mid-tier RLECs); Table 1 (showing the differences between the mid-tier and small RLECs).

with basic local service rate increases in 1999-2000, the $30 million in annual revenue from 1999-2000 would have decreased by approximately 20% to $24 million due to the line loss Mr. Laffey describes. In other words, because of their constant USF subsidies based on 10-year-old line counts, the RLECs are ***better*** off now than they were 10 years ago when the access rate reductions were implemented than they would have been had there been no reductions at all. But the access rate reductions in the *Global Order* were not intended to give RLECs such a windfall.

In particular, even if the RLECs had not rebalanced the revenue at all and left the toll and access rates the same, given industry trends the RLECs' access and toll minutes-of-use over this time have decreased, which would have reduced the resulting revenue. Using information recently released by the FCC, the volume of intrastate access minutes dropped by at least 22% on an industry-wide basis from 1999 through 2006.[27] Extrapolating the annual average decline through the end of 2008, the decline would be 29.5%. Yet because they are receiving the replacement revenue from other carriers who cannot choose to stop paying, the RLECs are still receiving $30 million a year nearly ten years later, when they would not be receiving that level of revenue in the absence of the USF. Indeed, if anything, Mr. Laffey's line loss evidence and Mr. Price's evidence regarding corresponding access minute declines suggests that the Commission would be well-justified in reducing each RLEC's USF draw by nearly 30% (or alternatively by that RLECs' individual percentage of line loss since 1999), even if it does nothing else.[28]

---

27 *See* Trends in Telephone Service, August 2008, issued by the FCC's Industry Analysis and Technology Division, Wireline Competition Bureau, Table 10.2 (VZ St. 1.1 (Price Rebuttal) Exhibit 2).

28 Compounding the inequity of the situation, the contributing base has declined as well over this period. (OCA St. 1(Loube Direct) at 32).

Mr. Laffey also notes that some of the companies have experienced even greater line loss than the average. One of those companies is North Pittsburgh, one of the mid-tier RLECs, which receives a large chunk of the annual USF subsidies. (*See* Exhibit JJL-2; Price Direct Table 1). This evidence alone is grounds to reduce North Pittsburgh's share of the USF.

The Commission should take immediate steps to decrease revenue flows from other carriers to the RLECs, not increase them. The USF is funded exclusively by other telephone carriers and was acknowledged at its creation to be nothing more than a "passthrough mechanism to facilitate the transition from a monopoly environment to a competitive environment – an exchange of revenue between telephone companies which attempts to equalize the revenue deficits occasioned by mandated decreases in their toll and access charges."[29] The anticipated "competitive environment" is here and it is high time to consider at least reducing, and eventually eliminating, the current USF.

CONCLUSION

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

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

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

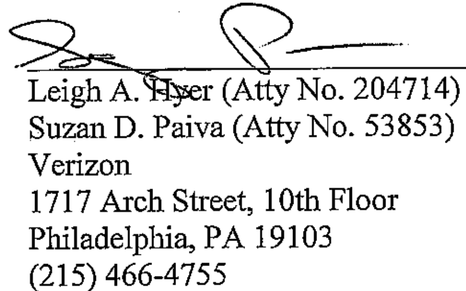
[29] *Global Order*, slip op. at 135.

(3) alternatively, if a residential rate cap is needed it should be set at least several dollars above $18 and should serve as a safe-harbor for review of RLEC rates and not under any circumstances as a starting point for RLEC USF claims;

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

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

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



Leigh A. Hyer (Atty No. 204714)
Suzan D. Paiva (Atty No. 53853)
Verizon
1717 Arch Street, 10th Floor
Philadelphia, PA 19103
(215) 466-4755

Dated: May 11, 2009

Attorneys for Verizon Pennsylvania Inc., Verizon North Inc. and MCImetro Access Transmission Services, LLC d/b/a Verizon Access Transmission Services