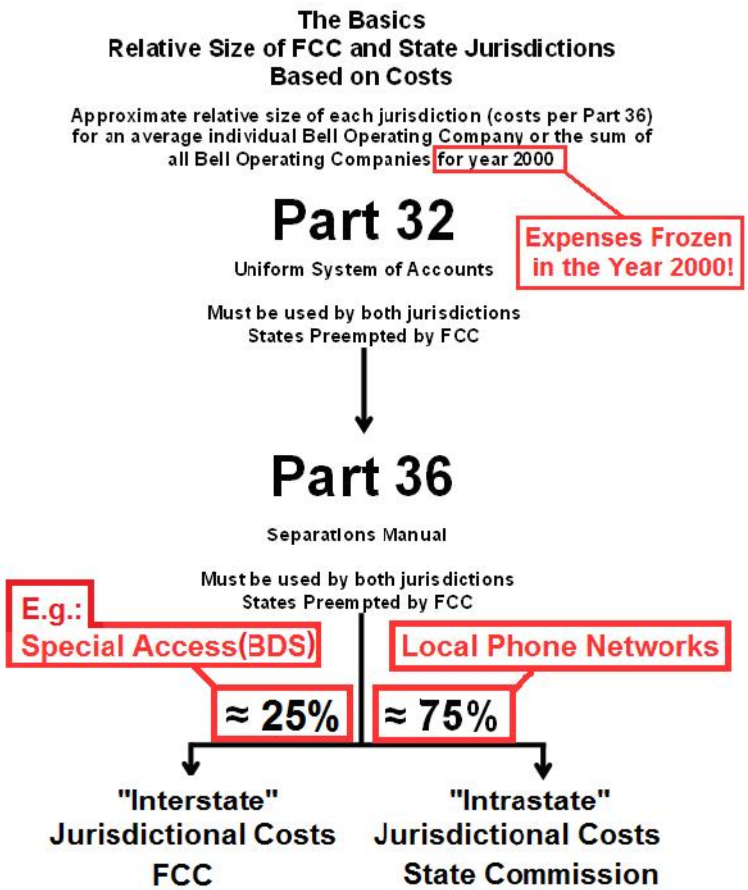
(CONFIDENTIAL)

The Hartman Memorandum



Published by

New Networks Institute

Paul Hartman

Bruce Kushnick

David Bergmann, Esq.

Fred Goldstein

Chuck Sherwood

Tom Allibone

Kenneth Levy, Esq.

W. Scott McCollough, Esq.

November 3rd, 2016

HARTMAN MEMORANDUM

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Declaration

The FCC has not examined the massive cross subsidies created by the FCC's own malformed and distorted cost allocation rules.

This includes the fundamental cross subsidy—that 75% of most network costs are paid by the local services (intrastate) while only 25% are paid by 'interstate' services, such as special access, recently renamed "Business Data Services". Worse, another set of rules created in 2001, requires the allocation of expenses to represent the year 2000—16 years ago, which has little to do with the connected, digital world of 2016.[1]

"Special access" are not special services but a fabricated regulatory classification that takes a wire from the state utility and claims it is no longer an 'intrastate' service (which are services within the state controlled by the state commission), but are 'interstate' services, which are for business data and broadband, and they are controlled by the FCC. – Same exact wire, however.

The FCC claims that it can determine pricing that will be just and reasonable.

The Hartman Memorandum proves that the FCC can never create just and reasonable pricing for special access services because the FCC's own cost allocation rules created massive financial cross subsidies between and among the state-based wired utilities, and the companies' other line of business, such as special access.

The Memorandum is accompanied by two other reports:

- **The History & Rules of Setting Phone Rates in America —The FCC's 'Big Freeze' & Cross Subsidies —** which supplies a history of the FCC and state rules discussed herein.
- **Fixing Telecom, Fixing Broadband Data Services** — which supplies a road map on how to use the Memorandum to get cities upgraded and bring in robust competition to lower prices. (Release date: TBA.)

Two Items Stand Out:

- **75%-25% Rule —** 75% of most network expenses are paid by the Local Service phone networks (intraLATA) vs any 'interstate' services, such as Special Access, which pays only 25%. This rule was created in 1984 and has not been adjusted or replaced for 32 years.
- **"Cost Allocation Rules" Were Set Based on the Year 2000 —** In 2001, the FCC created a series of rules pertaining to the allocation of expenses to match the year 2000—16 years ago. In 2001, Local Service was about 65% of revenues and it paid 65% of costs. In 2015, Verizon New York's Local Service revenues were 25% but it still paid

[1] We note that there are a host of caveats as different rules and calculations applied to different parts of the regulated networks. On top of this, the big freeze was applied to other expense areas, such as corporate operations or marketing. Moreover, the cross subsidies created by the rules allowed the affiliate subsidiaries to have different beneficial financial arrangements where they pay fractions of the market prices charged to competitors for use of the network or paid a fraction of the actual construction expenses used by Verizon Wireless for fiber optic build outs to the cell sites.

61.2% of all corporate operations expense. Access services, which had 47% of revenues only paid 28.6% of the corporate operations expenses.[2]

This Distortion of the Accounting has had Multiple, Direct and Harmful Impacts on All Services — Special access had a 66% “Earnings Before Interest Taxes Depreciation and Amortization”, (EBITDA) -- because it paid only a fraction of expenses while Local Service paid the majority. In fact, all of the ’interstate’ broadband networks, including the wires to the cell sites for Verizon Wireless or even FiOS TV, all paid fractions of the expenses and thus have very high profit margins.

Direct Harms to All Wired Services — Unfortunately, special access cannot be examined without looking at all of the other lines of business, from local service to the implications of massive cross subsidies that were designed and helped to create harmful public policies.
At the same time, these expenses made the local phone networks artificially unprofitable, which as been used as an excuse to ’shut off the copper’ or force customers onto ’more profitable’ wireless services. This has also been an excuse for not building out FiOS broadband to many areas throughout the East Coast.

The FCC’s Proposed Rules Do Not Address Cross Subsidies — The proposal does not fix the excessive profit margins nor examine that the FCC’s rule making doesn’t include the fact that local phone customers have been overcharged, having paid the excess profits. Moreover, the agency has never addressed the fact that these wires are part of the state utility as they are classified as Title II, and that the expenses paid are mostly ‘intrastate’ where the FCC does not have jurisdiction.

The FCC’s Plan Also Includes a Host of Proposed Actions that Will Cause Multiple Harms — For example, the FCC plans do not require the incumbents to share any new build-out of fiber optic special access services with high speeds with competitors, even though the majority of the expenses were paid for by local service under the FCC’s own rules, or rate increases agreed to by the state commissions.

Harm to Broadband and Internet Competition — Much of the incumbent’s retail business is in Internet access now, including DSL and FiOS and they are classified as interstate. In fact, anything that carries Internet is interstate. Thus, all of the growth areas, including competitive ones, are in the interstate basket, which is not paying its fair share. This also makes it easier for the ILECs to undercut "broadband" competition.

Harms to Users and Municipalities — As we discuss, Consumer Federation of America found over $75 billion in special access customer overcharging in just the last five years. Moreover, these financial distortions diverted monies to the affiliate companies, such as Verizon Wireless, that should have gone to upgrade and maintain communities’ network infrastructure for broadband and internet services.

The Cost Allocation Regulations have been Erased But Are Still In Use — There are those who, as a knee-jerk reaction, will say that the rules have been ‘forebeared’ – i.e., while the rules are still on the books they are no longer required. Unfortunately, the Verizon New York annual

[2] This Memorandum only focuses on Local Service and Access Services, and does not go into detail about the other revenue and expense areas for “Nonregulated”, “Black Hole” revenues, or revenues and expenses for affiliate companies, from Verizon Online to Verizon Wireless.

reports and matching reports from Massachusetts prove that the rules are still in use. But it also exposes that the price caps did not work[3]

The Hartman Memorandum walks through the accounting using actual data to show the massive financial overcharging underway.

The Primary Data—Verizon New York has been required to file detailed annual reports through 2015. But we have obtained other financial data from other Verizon states, as well as corporate financial transcripts, state filings, FCC filings, and even press releases covering all Verizon states. We also used FCC ARMIS data through 2007 to show that the same financial rules have been and continue to be applied in all AT&T and CenturyLink states.

Backstory

In 2002, the second version of AT&T (1984-2005), filed against the incumbent, wireline phone companies, which are now AT&T, Verizon and Centurylink. This is the summary on the FCC website.[4]

At the time, AT&T was a competitor to what is now AT&T and was renting the incumbent's networks to offer local and long distance services (and internet).

A quote from the opening of the original AT&T Petition, October 2002:[5]

> "As detailed below, there is now indisputable proof that: (i) large LECs, and particularly the Bell Operating Companies ("Bells"), retain pervasive market power in the provision of these services, (ii) the large ILECs are abusing that market power with patently unjust and unreasonable rates that impose a multi-

[3] Price caps allow for the company to keep the price of a service at a fixed rate, or incrementally increase based on some factor, like inflation, while the company's profits are not examined. This document proves that price caps failed to keep basic prices 'just and reasonable' as special access has excessive profits. Moreover, without serious accountability or enforcement, price caps are just another means for the company to make more profits, without fulfilling the commitments that got the company this financial largesse.

[4] https://www.fcc.gov/ecfs/search/filings?limit=100&proceedings_name=RM-10593&sort=date_disseminated,DESC

[5] https://ecfsapi.fcc.gov/file/6513297623.pdf

> billion dollar annual overcharge or tax on American businesses and consumers and also severely harm both local and long distance competition, (iii) the Commission's existing rules are incapable of addressing this worsening crisis, and, indeed, only exacerbate the problem, and (iv) the Commission therefore has a clear legal obligation promptly to reform its regulation to protect the public interest and to put an end to these monopoly abuses."

NOTE: "LECs" or "ILECs" are the local exchange companies, the state-based utilities. In 2002, the "Bell Operating Companies", controlled the access wires. Today, this represents AT&T, Verizon and CenturyLink.

And today, in 2016, any incumbent provider that controls these networks controls all of telecom, wired, wireless broadband, IP, and any future wireless services that arrive called "5G".

In 2007, the FCC stopped collecting its basic business and financial data on the incumbent phone companies, called "The Statistics of Common Carriers", which had started publication in 1939.

In 2015, the FCC collected data on special access, renaming it 'Business Data Services". This collection was very limited, as it collected information from companies who spent over $5 million in billings annually.

Based on this data, the FCC found that special access was a $45 billion dollar market in 2013, and that 60%, the majority, was still copper-based services, $27 billion. (We believe this is the low case scenario.) The data is supposed to be used for finally dealing with AT&T's original special access petition and setting a new direction.

In April, 2016, Consumer Federation of America (CFA) found massive overcharging of special access networks.[6]

> "Taking on one of the most pressing issues facing the current Federal Communications Commission (FCC), the Consumer Federation of America (CFA) today released a study that estimates that large incumbent telephone companies have engaged in abusive pricing practices for high-speed broadband "special access" services, with overcharges totaling about $75 billion over just the past five years. As a result, CFA estimates that the indirect macroeconomic loss to American consumers doubles that damage to a total in excess of $150 billion since 2010."

New Networks Institute's (NNI) analysis, which is based on Verizon New York's financial annual reports, dovetailed with the CFA data. NNI found massive cross subsidies of special access and all other lines of business with the state utility, leading to excessive profits for special access networks. NNI also found cross subsidies of Verizon Wireless, where wireline capex was diverted to fund wires to Verizon's cell sites. Verizon wireless is also paying a fraction of access fees other wireless carriers competitors pay to Verizon.

New Networks Institute and CFA have filed joint comments and reply comments in the special access proceedings with detailed analyses, as well as separate comments.[7]

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[6] http://consumerfed.org/press_release/cfa-study-finds-special-access-market-concentration-cost-consumers-and-the-u-s-economy-150-billion-since-2010/
[7] http://newnetworks.com/nnicfacomments/

Also in April 2016, INCOMPAS, the competitor association, cut a deal with Verizon, detailing a decrease in rates, and some other points. However, this would not fix the overcharging, and it is not based on actual financial reports but mathematical models, which hides the cross subsidies.

As of November 1st, 2016, the FCC has just floated a new proposed deal that cuts the competitors off at the knees and fixes none of the issues found by CFA or NNI.

What follows is the case against the carriers and the FCC, detailing that the FCC failure to fix the cost allocations rules to match reality and created a regime of massive cross subsidies – in all states, as there is no indication that any state has undertaken any examination of the cross subsidies between and among affiliates and the state utilities.

In short, there are multiple harms from the malformed accounting.

BACKGROUND

The Hartman Memorandum is part of "Fixing Telecom", a project by New Networks Institute, which started in 2010.

In December, 2015, New Networks Institute (NNI) launched a new report series called "Fixing Telecom" and published the first two reports. However, this project started in 2010. Most significantly, in May 2014, Public Utility Law Project, PULP, published "It's All Interconnected" written by Bruce Kushnick, with assistance from David Bergmann, Esq.

This report and previous work has been used as part of a petition for investigation by the Connect New York Coalition, which was filed with the NY State Public Service Commission in July 2014 and is an open proceeding.

In April 2016, Consumer Federation of America (CFA) and NNI filed joint comments and reply comments in the special access proceedings at the FCC.

- **Fixing Telecom Reports, Filings** http://newnetworks.com/fixingtelecomdocs/
- **Joint filings with CFA** http://newnetworks.com/nnicfacomments/

NNI is an independent expert consortium and was established in 1992 and over the last decade has gathered a team of independent experts, auditors and lawyers to work on projects, including "Fixing Telecom".

These reports were created by NNI's experts Paul Hartman, David Bergmann, Esq., and Bruce Kushnick, among others.

- **New Networks Institute Expert Team:** http://newnetworks.com/nniexperts/

Summary Articles, 2016

- *Verizon's Wireline Networks Diverted Billions for Wireless Deployments Instead of Wiring Municipalities, and Charged Phone Customers for It.*
- http://www.huffingtonpost.com/bruce-kushnick/verizons-wireline-network_b_12022492.html
- *Verizon's Boston Faux-FiOS, "One Fiber" Strategy Exposed*
- http://www.huffingtonpost.com/bruce-kushnick/verizons-boston-faux-fios_b_11291330.html?

REPORTS

September, 2016

- REPORT 1: How Municipalities and the States Can Fund Fiber Optic & Wireless Broadband Networks
- http://newnetworks.com/wp-content/uploads/Muniwirelesssept13FINALLY-3.pdf
- REPORT 2: DATA: Proving Verizon's Wireline Networks Diverted Capex for Wireless Deployments Instead of Wiring Municipalities
- http://newnetworks.com/report2datawirelinewireless/

December, 2015

- Verizon's Manipulated Financial Accounting & the FCC's Big "Freeze"
- http://newnetworks.com/report1executivesummary/
- REPORT 2: DATA REPORT
- http://newnetworks.com/report2data/

Primary Findings

- **The 75%-25 Rule has been In Place Since 1984.** Created in the 1980's, at the break up of the original AT&T, this rule allows 'interstate' services, such as special access, to pay only one-quarter of many of the network costs. At the same time, it assigns 75% of the majority of network expenses to the 'intrastate' category, i.e., the local utility networks and "local service".
- **The FCC's "Big Freeze" Is Still in Place Since 2001. —** In 2001, the FCC created a series of rules pertaining to the allocation of expenses to match the year 2000—16 years ago. In 2001, local service was about 65% of revenues and it paid 65% of costs. In 2015, Verizon New York's Local Service revenues were 25% but it still paid 61.2% of all corporate operations expense. Access services, which had 47% of the revenue only paid 28.6% of the corporate operations expenses.

- **Massive Cross-Subsidies Between and the State Wired Utility and Affiliates —** These fundamental FCC regulations have created massive cross subsidies of the state utility and all other affiliates of the companies.
- **No "Just and Reasonable" Prices for Special Access and Local Service —** The FCC cannot make any claims that special access service prices are ''just and reasonable" because of the cross subsidies of special access.

- **The State Utility and Customers Funded Special Access and Wireless —** Verizon New York, the state telecommunications utility, has cross subsidized all other Verizon lines of business that use the networks including Verizon special access services, Verizon Online, Verizon FiOS and especially Verizon Wireless.
- **How Did This Happen? —** Verizon's New York convinced state regulators that Verizon's FiOS and all fiber optic deployments are part of the state utility and Title II. This allowed Special Access services to not only use the networks, but also to not pay much of the network costs. And through the Big Freeze, this line of business also paid a fraction of the other expenses, like corporate operations.

  - Verizon New York's Special Access Services were $2 billion in 2015 and had an EBITDA of 66%; this was only the copper-based services.

- **The FCC Subscriber Line Charge —** (also considered an interstate access service) also has an EBITDA of 66%. This charge is on every Verizon bill for local phone service and now adds about $6.50 a month to each one. In a separate decision, the FCC decided that it would not examine the profits of this item and that any service that substituted for local wireline service can also charge this additional fee, which is direct access revenue to the company.
- **The FCC's accounting rules have been 'forebeared'** but are still being used in the financial accounting in every state. The FCC has not considered or even mentioned that fact.
- **The FCC's Analysis Is Not Based on Actual Financial Information But Formulas —** The FCC stopped collecting basic financial and business information in 2007. However, Verizon NY is still required to submit annual report in New York.
- **No Audits or Investigations by the FCC or States —** There have been no audits of the affiliate transactions for over 16 years by either the FCC or the state commissions.
- **No Recognition of the Special Access as Part of the State Utility —** The wires used for special access are the same wires for local service. However, the FCC has not addressed this issue.
- **No Recognition of the Expenses Being Paid by Intrastate, State-Based Local Networks —** With 60%+ of expenses in many categories being paid by the local phone customer as

part of the state utility, the FCC is negligent in not examining this fact and the cross subsidies in place that makes special access so profitable.

- **No Accounting of Total Lines in Service —** The FCC and the telcos are undercounting lines, claiming that only basic, copper-based phone service are 'access lines'. In fact, special access, DSL, FiOS and every other service that uses the same utility networks and are also Title II access lines.
- **Failure To Examine All of the Facts Created Multiple Harmful Public Policies —**There is a long list of harms that have been caused by these policies.

  - Local service customers impacted: Local phone customers were required to illegally fund most of Verizon other affiliate businesses from Verizon Online to Verizon Wireless.
  - These cross subsidies made local service appear unprofitable, which has been used as a claim to 'shut off the copper' wires.
  - The unprofitability was used as an excuse to a) not upgrade the existing copper wires and b) not build out the networks to more rural or 'low income' areas.
  - Anti-competitive actions require FCC investigations. Not fixing special access directly harms all competitors who pay retail prices.
  - Verizon Wireless did not pay for most construction and is underpaying for access fees. Separately, Verizon Wireless was able to get Verizon Now York to build the wires to the cell sites as part of the state utility's construction budgets, and has also been paying a fraction of what other competitors pay for special access services.

We created a separate report to highlight the extensive cross subsidies and underpayments of Verizon Wireless.[8]

"Proving Verizon's Wireline Networks Diverted Capex for Wireless Deployments Instead of Wiring Municipalities, and Charged Local Phone Customers for It."

- **This Problem Is National in Scope —** The FCC's rules are federal and applied to all state jurisdictions. As we demonstrate, the last data published by the FCC showed the same, identical cross subsidies in every state.

[8] http://newnetworks.com/report2datawirelinewireless/

1.0 The 75%-25% Rule Was Established in the 1980's and is Still in Place Today.

Comments filed by SureWest Communications on April 18, 2011 detailed the rule's origins.[9]

> "Subscriber Plant Factor Reform: Sections 36.154(a) through (c) of the Commission's rules set forth procedures for allocating loop costs between the state and interstate jurisdictions. Prior to 1982, loop costs were allocated using a traffic sensitive interstate allocation factor known as the subscriber plant factor ("SPF").[10] By the early 1980's, increases in relative interstate usage caused carriers' interstate subscriber plant factors to escalate rapidly, reaching the maximum interstate cost allocation of 85 percent for some carriers. **As a result, the Commission, in consultation with the Federal-State Joint Board,[11] instituted a flat-rate 25 percent interstate allocation factor to be phased in during an eight-year transition period, 1986 to 1993.[12]** Concurrent with the institution of the new SPF transition period, the Commission established the universal service fund allowing ILECs with high local loop costs to allocate an additional portion of those costs to the interstate jurisdiction.[13] The universal service fund was phased in during the same eight-year transition period as the new subscriber plant factor. In order to ensure that a carrier's interstate cost allocation would not drop precipitously during the transition, the rules specified that the combined interstate factor determined by considering the interstate subscriber plant factor and the universal service amount, would decrease by no more than five percent in any one year.[14] Carriers with a very high subscriber

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[9] *In the Matter of Connect America Fund,* WC Docket No. 10-90; *A National Broadband Plan for Our Future,* GN Docket No. 09-51; *Establishing Just and Reasonable Rates for Local Exchange Carriers*, WC Docket No. 07-135; *High Cost Universal Service Support*, WC Docket 05-337; *Developing a Unified Intercarrier Compensation Regime*, CC Docket No. 01-92; *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45; *Lifeline and Link Up* , WC Docket No. 03-109.

[10] See, 47 C.F.R. Part 67 (1980). The subscriber plant factors were determined by weighting toll minutes of use by factors greater than 1.0, weighting local minutes of use by 1.0, and determining the relative state and interstate proportions. Regardless of the relative proportions determined in this way, the rules limited the interstate subscriber plant factors to a maximum of 85 percent.

[11] See, 47 U.S.C. § 410; *Amendment of Part 67*, Notice of Proposed Rulemaking and Order Establishing a Joint Board, 78 FCC 2d 837 (1980).

[12] See, *Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board*, Decision and Order, 89 FCC 2d 1 (1982) (adopting Joint Board's recommendation to freeze the subscriber plant factor at 1981 levels); Decision and Order, 96 FCC 2d 781 (1984) (adopting Joint Board's recommendation to establish a fixed 25 percent interstate allocation factor); *MTS and WATS Market Structure, Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board, Decision and Order*, 50 Fed. Reg. 939 (1985) (revising the transition period to eight years with a limit of five percentage points reduction per year).

[13] See, 47 C.F.R. Part 36, Subpart F.

> plant factor were directed to extend their transition periods, subject to the five limitation, until the 25 percent interstate allocation was reached."[15] (Emphasis added.)

2.0 The Big Freeze

FCC Freezes the Expense Ratios to the Year 2000

Local rates are approved by the NYPSC to recover costs, primarily expenses, allocated to local service.[16] Of the two "external" allocation systems,[17] Jurisdictional separations[18] has historically been the most influential in the determination of local expenses.

The FCC writes.

> "Jurisdictional separations is the process of apportioning regulated costs between the interstate and intrastate jurisdictions. The primary purpose of separations is to determine whether a local exchange carrier (LEC)'s cost of providing regulated services are to be recovered through its rates for intrastate services or through its rates for interstate services. The first step in the current separations process requires carriers to apportion regulated costs among categories of plant and expenses. In the second step of the current separations process, the costs in each category are apportioned between the intrastate and interstate jurisdictions. Once costs are separated between the jurisdictions, carriers can then apportion their interstate regulated costs among their interexchange services and their intrastate costs among intrastate services."

2.1 The FCC's Rules Freeze Expense Allocations Based on the Year 2000.

Per Part 36:

> "§ 36.3 Freezing of jurisdictional separations category relationships and/or allocation factors
>
> (a) Effective July 1, 2001, through June 30, 2017, all local exchange carriers **subject to Part 36 rules** shall apportion costs to the jurisdictions using their study area and/or exchange specific jurisdictional allocation factors calculated

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[14] See, *Amendment of Section 36.154 of the Commission's Rules*, Memorandum Opinion and Order, 6 FCC Rcd 1873, 1874 (1991).

[15] Id.

[16] Part 36 allocated Verizon – New York's costs between the interstate (FCC) and intrastate (NYPSC) jurisdictions. The costs allocated to intrastate are further allocated between "intrastate" services by the NYPSC. Since local has historically been the least competitive and is by far the largest intrastate service, it has and continues to recover the most intrastate costs.

[17] 47 C.F.R §§ 64.901 – 64.905 - Subpart I - Allocation of Costs and 47 C.F.R Part 36 Jurisdictional Separations Procedures; Standard Procedures for Separating Telecommunications Property Costs, Revenues, Expenses, Taxes and Reserves for Telecommunications Companies.

[18] 47 C.F.R. Part 36.

during the twelve month period ending December 31, 2000, for each of the categories/sub-categories as specified herein" (emphasis added)

2.2 The 'Big Freeze' has been Kicked Down the Road for 15 Years.

In 2001, the FCC "froze" the calculations of expenses that are used in every state, based on the year 2000 — and this freeze will continue until the year 2017.[19] It now assigns the majority of all expenses to the Local Service category, making it look unprofitable. There have been no audits or investigations by either the state commissions or the FCC for the last 15 years. And the kicker— this same phrase has appeared in some form since 2000— the freeze was to continue **"until comprehensive reform could be achieved".**

Time Line:

- **2000:** "On July 21, 2000, the Joint Board issued its 2000 *Separations Recommended Decision*, recommending that, **until comprehensive reform could be achieved,** the Commission should freeze the expenses."

- **2001:** "The Commission ordered that the freeze would be in effect for a five-year period beginning July 1, 2001, or until the **Commission completed comprehensive separations reform, whichever came first**."

- **2006**: "On May 16, 2006, in the *2006 Separations Freeze Extension and Further Notice*, the Commission extended the **freeze for three years or until comprehensive reform could be completed, whichever came first**. The Commission concluded that extending the freeze would provide stability to LECs pending further Commission action to reform the… rules**, and that more time was needed to study comprehensive reform.** The freeze was subsequently extended by one year in 2009, 2010, and 2011 and by two years in 2012."

- **2010:** "On March 30, 2010, the State Members of the Joint Board released a proposal for interim and comprehensive separations reform… On September 24, 2010, the Joint Board held a meeting with consumer groups, industry representatives, and state regulators to discuss interim and comprehensive reform…"

- **2011:** "In 2011, the Commission comprehensively reformed **the universal service and intercarrier compensation systems and proposed additional reforms. The Joint Board is considering the impact of the reforms** proposed by the *USF/ICC Transformation Order* and any subsequent changes on its analysis of the various approaches to separations reform."

- **2014-2017: "**On March 27, 2014, the Commission sought comment on extending the freeze once more. We extend through June 30, 2017…. We conclude that extending the freeze will provide stability to carriers that must comply with the Commission's jurisdictional separations rules **while the Joint Board continues its analysis of the jurisdictional separations process**."

[19] http://apps.fcc.gov/ecfs/document/view?id=7521314401

3.0 Examples of How the Freeze and 75% Rule Impacted Expenses.

3.1 Local Phone Customers Were Overcharged for Cross Subsidies to Fund Special Access.

This is an excerpt from the 2015 Verizon New York annual report filed with the NY State Public Service Commission. Neither the FCC nor any consultant or expert has bothered to examine the actual financial books, but instead they rely on mathematical formulas without accurate data inputs to base their claims.

Verizon New York Local Service and Access Revenues and Expenses, 2015

Operating Revenues	Local Service	Access Service
(Special Access)		$2,008,589,749
Total Operating Revenues	$1,314,760,587	$2,508,453,620
Operating Expenses		
Plant Specific & Non-Specific	$1,470,969,520	$716,168,027
Subtotal	$1,731,367,648	$ 843,549,033
EBITDA	-132%	66%

Sources: Verizon New York 2015, New Networks Institute

According to Verizon NY's 2015 annual report, local service brought in $1.3 billion and had an EBITDA of -132%. This is in contrast to access fees, which were $2.5 billion in revenue and had and EBITDA of 66%. (Special access was $2 billion and represents 80%+ of the total.)

One would say that 'Local Service' was losing money until one examines the network costs ("plant specific and non-plant specific") and notices that local service paid $1.47 billion, which is in contrast to access services only paying $716 million, literally half of what local service paid. i.e., local service paid 117% of revenue while access paid 29% of revenue.

Local Service revenues are mostly from the copper-based "POTS", "Plain Old Telephone Service", lines. Verizon has stated it is no longer upgrading and maintaining these lines, the retail copper lines.

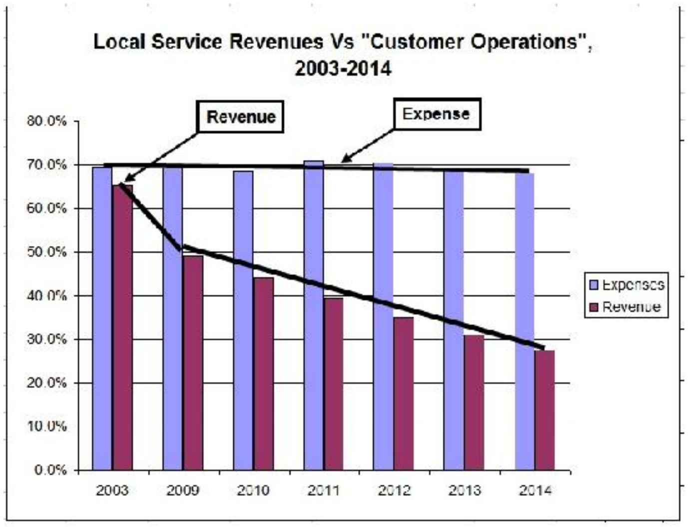
How can local service be paying the majority of network expenses? And how can access services have a 66% EBITDA for mostly copper-based services while the same exact wires have massive losses?

NOTE: This financial data represents the "$25+ billion" of special access revenues. There is an additional $20 billion not on these financial books, but the majority of expenses appears to be embedded in these financial books.

3.2 A More Striking Version of this Is the Application to Customer Service Expenses.

As this chart shows, Local Service revenues have been in decline since 2003, from 65% down to 28%, in 2014. However, there was virtually no deduction in the expenses for "Customer Operations", which remained around 68% of this expense was put into Local Service.

While an audit is needed to uncover what were the actual expenses for customer operations for this 11 year period that was generated by the local service category—all of this excess was used as an excuse to raise local rates multiple times in New York.



To understand the history of ratemaking in America, how these calculations work and the FCC rules that have been applied, see: **The History & Rules of Setting Phone Rates in America**

4.0 How It Works: Applying the Accounting Rules

Virtually all of the majority expenses we have discussed in this report have been placed into Local Service. For example, here is "Marketing" expenses:

> "§ 36.372 Marketing
>
> Account 6610 (Class B telephone companies); Accounts 6611 and 6613 (Class A telephone companies). The expenses in this account are apportioned among the operations on the basis of an analysis of current billing for a representative period, excluding current billing on behalf of others and billing in connection with intercompany settlements. Effective July 1, 2001, through June 30, 2017, all study areas shall apportion expenses in this account among the jurisdictions using the analysis, as specified in § 36.372(a), during the twelve- month period ending December 31, 2000"

If, in 2000, the Account 6610 for marketing expense were allocated 10% interstate and 90% intrastate based on the revenues in 2000 per the Separations Manual, the results would be as follows:

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Calculation of frozen factors - example								
		Used to calculate jurisdictional factor for 6610			<<<<<<<<< 2000 >>>>>>>>>			
	Account	Actual	Actual	Actual	Actual	Actual	6610	6610
Year	6610	Total Revenue	IS Revenue	ST Revenue	IS %	ST %	IS $	ST $
2000	$ 1,000,000	$ 1,000,000,000	$ 100,000,000	$ 900,000,000	10.0%	90.0%	$ 100,000	$ 900,000

NOTE: "IS" is "Interstate" service, "ST" is State-based (Intrastate) service.

Continuing the above example, in the intervening years, the same jurisdictional factors calculated for 2000 (10% interstate and 90% intrastate) would be used regardless of the actual revenues. For example, if the total for marketing account numbered 6610 was $1,000,000 in 2005, was $2,000,000 in 2010, and $3,000,000 in 2015, the results are shown below: The expenses per year are 'frozen' regardless of the revenues generated by the category.

Application of frozen factors - example					
	Account	Frozen	Frozen	6610	6610
Year	6610	IS %	ST %	IS $	ST $
2005	$ 1,200,000	10.0%	90.0%	$ 120,000	$ 1,080,000
2010	$ 2,000,000	10.0%	90.0%	$ 200,000	$ 1,800,000
2015	$ 3,000,000	10.0%	90.0%	$ 300,000	$ 2,700,000

To illustrate the effect of frozen factors for such a long period of time, in the example below, interstate revenues grew faster than intrastate revenues.

Results if jurisdictional factors had not been frozen								
		Used to calculate jurisdictional factor for 6610						
	Account	Actual	Actual	Actual	Unfrozen	Unfrozen	Unfrozen	Unfrozen
Year	6610	Total Revenue	IS Revenue	ST Revenue	IS %	ST %	IS $	ST $
2005	$ 1,200,000	$ 1,100,000,000	$ 200,000,000	$ 900,000,000	18.2%	81.8%	$ 218,182	$ 981,818
2010	$ 2,000,000	$ 1,200,000,000	$ 500,000,000	$ 700,000,000	41.7%	58.3%	$ 833,333	$ 1,166,667
2015	$ 3,000,000	$ 1,400,000,000	$ 900,000,000	$ 500,000,000	64.3%	35.7%	$ 1,928,571	$ 1,071,429

The "frozen" and "unfrozen" differences between intrastate (ST) allocated Account 6610 costs are shown below:

Effect of frozen factors on State Costs - Example					
				<<<<<< State Difference >>>>>>	
	Account	Unfrozen	Frozen	$	%
Year	6610	ST $	ST $	Unfrozen - Frozen	Unfroz to Froz
2005	$ 1,200,000	$ 981,818	$ 1,080,000	$ (98,182)	-9.1%
2010	$ 2,000,000	$ 1,166,667	$ 1,800,000	$ (633,333)	-35.2%
2015	$ 3,000,000	$ 1,071,429	$ 2,700,000	$ (1,628,571)	-60.3%

Because these frozen factors are so old, bordering on ancient, it may seem much more reasonable that a significantly lower proportion of 6610 should be allocated to the state jurisdiction, mainly 60.3% less in 2015. However, such is not the case.

Part 36 rules are preemptive on the state commissions. In other words, all ILECs subject to Part 36 and their respective state commission have to follow the Part 36 rules that determine how large its confiscation[20] liability is, mainly the costs allocated to the state jurisdiction per Part 36. These costs are recovered in intrastate rates, primarily local, approved by the state commission.

Continuing the example of 6610, since Verizon NY is regulated by the NYPSC, the intrastate portion is the responsibility of the NYPSC and must approve rates that will allow recovery of legitimate expenses and provide a reasonable profit in order to prevent confiscation under the 5th amendment.

And it is a great deal of money. This excerpt for the Verizon New York's 2012 state-filed annual report shows the "Plant Specific" charges (usually primarily maintenance costs) for everything from "poles" to "aerial conduit", i.e., wires, and it represented $818 million dollars in 2012. Each of these intrastate expense amounts were the product of using factors frozen in 2000.

2 Annual Report of VERIZON NEW YORK INC. | For the period ending DECEMBER 31, 2012

44. OPERATING EXPENSES BY CATEGORY (Continued)

		This Year	Last Year
	Plant Specific Operations (cont.)		
	Cable and Wire Facilities Expenses		
6411	Poles	18,508,378	30,474,892
6421	Aerial Cable	425,050,765	453,097,508
6422	Underground Cable	135,507,836	160,554,502
6423	Buried Cable	66,209,563	73,550,685
6424	Submarine Cable	56,291	55,952
6425	Deep Sea Cable	0	0
6426	Intrabuilding Network Cable	13,572,152	10,335,106
6431	Aerial Wire	14,543,683	20,626,428
6441	Conduit Systems	144,222,008	124,060,139
6410	Cable and Wire Facilities Expenses	817,670,676	872,755,212

The primary intrastate services were "intrastate interLATA access", "intrastate intraLATA access", "intrastate toll" and local; – i.e., Long distance calls within the state and local calling. Many state commissions were convinced that intrastate access rates (both interLATA and intraLATA) should be equal to interstate access rates. Due in large part to the FCC use of subscriber line charges (SLCs) and federal Universal Service Funding, interstate access rates were approaching incremental costs[21].

[20] Per the 5th Amendment "…No person .....{shall be} deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation. Because telephone is a public utility and its rates are regulated, the regulator may not set rates so low as to be a takings or confiscatory. In practice this means that a telephone utility is entitled to receive its legitimate expenses and a return or profit on its investment. For a state commission, Part 36 determines the total intrastate costs (expenses and investment) that must be recovered in the total of all intrastate revenues. In those cases where not all intrastate services rates are regulated by the state commission, additional adjustments should be made.

[21] Interstate Carrier Common Line (CCL) rates were 0. These charges were designed to recover the intestate costs associated with the local loop, i.e., per Part 36, 25% of total local loop costs. Per economic theory, interstate rates should only recover the incremental costs of the common loop. However, since 25% of the costs of the local loop were allocated to interstate, the FCC recovered their Part 36 determined share of the local loop through interstate SLCs and federal USF, primarily the High Cost Fund (HCF) and Interstate Common Line Support (ICLS).

In the case of the local loop, 75% of the costs associated with the local loop were allocated to intrastate. Since the interstate carrier common line access charge was $0.00, for those states mirroring interstate access rates, the intrastate carrier common line charge was also $0.00. Therefore intrastate access rates did not recover any of the 75% of the local loop costs allocated to the intrastate jurisdiction. Therefore, local service rates effectively had to recover all of the local loop costs allocated to the intrastate jurisdiction.

An example of local loop costs are the Plant Specific Operations - Cable & Wire Facilities (C&WF) Plant Specific expenses. These expenses are primarily the maintenance costs associated with the copper and fiber facilities. These facilities can be used for such intrastate services as private line/special access; message trunk and message local loop. Message local loop is by far the largest C&WF investment. Since Plant Specific Operations – C&WF expenses are allocated on the basis of the related investment, message local loop, as the largest C&WF investment, will receive the largest share. As explained above, if intrastate access rates mirror interstate access rates, intrastate interLATA and intrastate intraLATA services will not contribute any revenues to recover theses costs. Therefore local will be left to recover these costs.

And this is a very partial list showing that most, if not all expenses for everything from customer service to the network infrastructure technology.

Examples of Categories that Were Frozen Since 2000,
(Source: FCC)

- § 36.378 Category 2 Customer services
- § 36.377 Category 1 -Local business office expense
- § 36.382 Category 3 -All other customer services expense
- § 36.381 Carrier access charge billing and collecting expense.
- Subpart B -Telecommunications Property
- Central Office Equipment
- § 36.124 Tandem switching equipment -Category 2
- § 36.125 Local switching equipment -Category 3

- Accounts 2210, 2211, and 2212 to Category 3,
- Account 2210, 2211, 2212 and 2215 to Category 3,
- Account 2220, Operator Systems
- Accounts 2230 through 2232
- Account 2410
- Account 2310
- Account 2410
- Account 6620-Services

This is from a 2010, Notice of Proposed Rulemaking at the FCC that questioned this allocation of costs to local service.[22]

[22] http://apps.fcc.gov/ecfs/document/view?id=7020409931 Notice of Proposed Rulemaking, CC Docket 80-286, March 29th, 2010

> 4. The jurisdictional separations process itself has two parts. In the first step, incumbent LECs assign regulated costs to various categories of plant and expenses. In certain instances, costs are further disaggregated among service categories.[7] In the second step, the costs in each category are apportioned between the intrastate and interstate jurisdictions. These jurisdictional apportionments of categorized costs are based upon either a relative use factor, a fixed allocator, or, when specifically allowed in the Part 36 rules, by direct assignment.[8] For example, loop costs are allocated by a fixed allocator, which allocates 25 percent of the loop costs to the interstate jurisdiction and 75 percent of the costs to the intrastate jurisdiction.[9]

The above chart shows that investment was also subject to the freeze of 2000. In addition to freezing the interstate/intrastate allocation factor, the categorization factor was also frozen in 2000. So all new construction costs (actual equipment/facilities and capitalized labor costs) would be categorized between the message loop, message trunk, interstate special access and intrastate special access/private line categories using the same categorization % as in 2000[23]. Once again, message local loop as the largest category in 2000 would still receiver the largest share, despite the fact the other categories, e.g., interstate special access is growing much faster now than in 2000.

4.1 Calculating the Freeze, 75%-25% Rules and Allocation Factors for Verizon NY.

APPENDIX II (Spreadsheet on Request) supplies a full examination of Verizon NY's financial results, with all of the calculations used to determine the expense allocations, from 2000-2015**.**

Calculating the Freeze Using Actual Financials from Verizon NY

This is an excerpt for the years 2000, 2007 and 2015, and it supplies "Total Basic Local Service", "Special Access Revenues", "Marketing" expenses, and "Plant Specific Expenses"

[23] For example, total C&WF is categorized to interstate special access in the same % as in 2000, despite the fact that over the last 10 years interstate special access revenues have been growing much faster than any other category. If the revenues are growing faster than the allocated costs, then the profit from that service could be very high.

[29] We use access expenses for these categories as separate expenses for special access are not broken out

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Excerpts from Verizon New York's Financial Accounting, 2000-2015

		Verizon	New York	January 2000 To December 2015		
NYNY	FCC REPORT 43-04	Year of the Big Freeze - Categories and Jurisdictional Allocations of Categories				
Row	Row Title	Subj Sep	Sep ST	Sep IS	% ST	% IS
2000	TOTAL BASIC LOCAL REVENUES	$ 4,658,057	$ 4,658,057	$ -	100.0%	0.0%
	SPECIAL ACCESS REVENUES	$ 680,591	$ -	$ 680,591	0.0%	100.0%
2007	TOTAL BASIC LOCAL REVENUES	$ 2,436,274	$ 2,436,274	$ -	100.0%	0.0%
	SPECIAL ACCESS REVENUES	$ 1,242,821	$ 12,816	$ 1,230,005	1.0%	99.0%
2015	TOTAL BASIC LOCAL REVENUES	$1,029,137	$1,024,232	$4,904	99.5%	0.5%
	SPECIAL ACCESS REVENUES	$2,008,590		$ 2,008,590	0.0%	100.0%
2000	**TOTAL MARKETING EXPENSES**	$ 307,762	$ 228,195	$ 79,567	74.1%	25.9%
2007	**TOTAL MARKETING EXPENSES**	$ 285,423	$ 207,385	$ 78,038	72.7%	27.3%
2015	**TOTAL MARKETING EXPENSES**	$ 246,186	$ 163,508	$ 82,678	66.4%	33.6%
2000	**PLANT SPECIFIC EXPENSES**	$ 1,858,216	$ 1,235,908	$ 622,308	66.5%	33.5%
2007	**PLANT SPECIFIC EXPENSES**	$ 1,769,210	$ 1,157,099	$ 612,112	65.4%	34.6%
2015	**PLANT SPECIFIC EXPENSES**	$1,505,559	$ 1,021,910	$ 483,649	67.9%	32.1%

- **Subj Sep** -- Subject to Separations.
- **Sep IS**-- Interstate Services (including Special Access)
- **Sep ST** -- Local and "In State" Services (IntraLATA)

NOTE: The 2015 Verizon Annual Report was released in July 2016. This is the 'freshest' data available.

Walking through these numbers demonstrates that while the revenues of local service have been in steep decline, the special access revenues have grown 195%. And yet, the expenses were almost flat since the year 2000. The expenses for "plant specific" expenses, (which are for construction and maintenance of the networks) were divided up so that in 2015, 67.9% of these capx expenses were put into the local phone networks, while access services (special access was about 80% in 2015), only paid 32%. These percentages of expense allocations have been within a rounding error since the year 2000, 16 years ago.

Revenues:

- Local service declined from $4.7 billion in 2000 to $1. billion in 2015
- Special access service went from $680 million in 2000 to $2. billion in 2015

Expenses[29]

- **Marketing** was charged:
- 74.1% to local service in 2000, Access paid 25.9%
- 66.4% to local service in 2015, Access paid 33.6%

- **Plant Specific expenses** were charged:
- 66.5% to local service in 2000, Access paid 33.5%
- 67.9% to local service in 2015, Access paid 31.1%

This, of course, makes no sense. Local service is primarily the copper wires for POTS service. There are no marketing charges for this service. And “plant specific” include construction and maintenance costs—Verizon is not upgrading or even maintaining these wires.

4.2 Forbearance and the Question of Local Rates

In its Order released on May 17, 2013, the FCC granted much of the forbearance petition of USTA[30]. In this order, the FCC forbore from enforcing all of the Part 36[31] separations rules as well as other rules[32] for all price cap ILECs[33]. Thus for all practical purposes, these rules disappear for all price cap ILECs.

As stated earlier, Part 36 rules are preemptive on the state commissions. This is to make sure that the costs are recovered in the interstate and intrastate jurisdictions such that the amount allocated to the interstate jurisdiction plus the amount allocated to the intrastate jurisdiction is exactly equal to the total amount. This is true for each and every property cost, revenue, expense, tax and reserve identified in Part 36. So Interstate per Part 36 + Intrastate per Part 36 = Total.

Per the forbearance order, Part 36 rules do not apply to the interstate jurisdiction. Therefore interstate per Part 36 could be expressed as “undefined”. Mathematically the historical Part 36 formula no longer works. Intrastate = Total – Interstate where Interstate is “undefined”, cannot be solved[34].

If Part 36 no longer identifies intrastate jurisdictional costs, what should be used to define local costs? Since 2000, there have substantial increases in non-regulated services, interstate services (interstate special access), preemption of intrastate interLATA access rates by the FCC, etc. The Part 36 rules that defined intrastate costs to prevent confiscation are no longer relevant. Therefore the state commission’s confiscation liability as defined historically per Part 36 is likewise no longer relevant or “undefined”.

4.3 Conclusion to the Big Freeze: Time for a Big Thaw.

It may be time to set local rates in an economically efficient manner. Since economic theory espoused by the ILEC industry and FCC indicates that setting rates at incremental costs result in the most efficient rates, incremental may be a good place to start. If allocations need to be made, the changes in services outlined above could be allocated their reasonable share as determined by the state commission.

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[30] United States Telecom Ass’n Petition for Forbearance Under 47 U.S.C. § 160(c) from Enforcement of Certain Legacy Telecommunications Regulations, Order, 28 FCC Rcd 2605, 2608

[31] 47 C.F.R Part 36 Jurisdictional Separations Procedures; Standard Procedures for Separating Telecommunications Property Costs, Revenues, Expenses, Taxes and Reserves for Telecommunications Companies

[32] 47 C.F.R §§ 64.901 – 64.905 - Subpart I - Allocation of Costs as well as other Part 32 rules involving affiliate transactions, Continuing Property Records, etc.

[33] This forbearance order was in direct response to petitions filed by USTA, price cap ILECs, etc. So the price cap ILECs wanted these rules to be forborne from and the consequences of an approval of their petitions. It was not done on the FCC’s own motion or a petition of an opposing party.

[34] Logically it is difficult to argue that the forborne Part 36 rules must preemptively apply to the state commissions. Clearly the original intent of the preemption was to make sure that both the FCC and state commissions followed the same jurisdiction cost rules. If the FCC is no longer following the Part 36 rules, the state commissions are likewise no longer obligated to follow Part 36 rules.

The previous Account 6610 chart might be updated as follows:

Year	Account 6610	Frozen IS %	Frozen ST %	Frozen ST $	Incremental ST $	Incremental ST %
2005	$1,200,000	10.0%	90.0%	$1,080,000	N/A	N/A
2010	$2,000,000	10.0%	90.0%	$1,800,000	N/A	N/A
2015	$3,000,000	UND	UND	UND	$ 300,000	10.0%

If local rates were set to recover $300,000 rather than the majority of the $2,700,000 costs (90% of $3,000,000) that would have been allocated to the state jurisdiction before the forbearance order. Applying this to all the costs now being recovered through today's local rates, tomorrow's local rates could be reduced dramatically and/or advanced services could be available universally at reasonable rates.

5.0 The Application of these FCC Rules Impacted Every Phone Company.

Findings

NOTE: Unless otherwise stated, all statistics will be based on these core 16 companies. And the data used is from the FCC's ARMIS database for the last year available, 2007.

5.1 Local Service Was 60% of Revenues; Access Was 40% in 2007.

America's Local Incumbent Telecommunications Utility Revenues, 2007

Total Revenue	Separations	Local	Access	Special	Local	Access
AT&T-Illinois Bell	$ 3,173,078	$ 2,148,308	$ 1,024,771	$ 550,271	68%	32%
AT&T-Southwestern - Kansas	$ 675,303	$ 395,444	$ 279,859	$ 168,022	59%	41%
AT&T-Ohio Bell	$ 1,935,758	$ 1,243,744	$ 692,015	$ 374,386	64%	36%
AT&T-Pacific Bell - California	$ 8,293,546	$ 5,388,971	$ 2,904,575	$ 1,624,412	65%	35%
AT&T-BellSouth-Tennessee	$ 1,417,799	$ 972,406	$ 445,393	$ 187,889	69%	31%
AT&T-Southwestern - Texas	$ 5,945,149	$ 3,929,164	$ 2,015,985	$ 1,139,056	66%	34%
Centurylink-Qwest-Colorado	$ 1,760,156	$ 990,489	$ 769,667	$ 449,681	56%	44%
Centurylink-Qwest-Oregon	$ 733,790	$ 417,976	$ 315,814	$ 172,844	57%	43%
Verizon-GTE California	$ 2,393,161	$ 1,459,317	$ 933,844	$ 509,150	61%	39%
Verizon Florida LLC	$ 1,314,880	$ 756,671	$ 558,209	$ 309,299	58%	42%
Verizon-Maryland	$ 2,053,622	$ 1,192,415	$ 861,207	$ 523,570	58%	42%
Verizon NE - Massachusetts	$ 2,206,580	$ 1,293,231	$ 913,349	$ 552,920	59%	41%
Verizon New Jersey	$ 3,004,789	$ 1,684,260	$ 1,320,529	$ 793,502	56%	44%
Verizon New York Telephone	$ 5,443,458	$ 3,226,212	$ 2,217,246	$ 1,332,619	59%	41%
Verizon Pennsylvania	$ 3,009,086	$ 1,716,155	$ 1,292,931	$ 768,640	57%	43%
Verizon Washington D.C.	$ 547,163	$ 299,280	$ 247,883	$ 159,618	55%	45%
Percent of Revenue					**60%**	**40%**
revenue	**$ 43,907,318**	**$ 27,114,043**	**$ 16,793,277**	**$ 9,616,479**		

The columns are:

Revenues

- **Separations —** are the total revenues examined by the state commission and filed with the FCC (which does not include "black hole" revenues"). And they are used to determine which services are 'intrastate" and in the domain of the state commission's jurisdiction, and ‘interstate’, which is federal and under the FCC’s jurisdiction. And all of this has extensive caveats..

- **Local Service — (**sometimes referred to as “Intrastate” or “State”), are mainly the revenues from local basic phone service, POTS, which related to the deployment plans. add on features.
- **Access —** are a group of ‘network access’ services, which include “Special Access”. Access services are fees for connections to the wired networks, or are now the separate business broadband and data access lines, as well as “backhaul”, or “middle mile” services that carry calls (including wireless calls) to connect with other parts of the networks to complete the call or data transfer.
- **Special Access —** has become a separate ‘hidden network’, as discussed in other reports. In this presentation, Special Access are revenues or expenses that are a subset of the total Access category.

Percentage

- **Local Service & Access** — This shows the relative size of the revenues for each category. Thus, AT&T-Illinois had 68% of the revenues still classified as Local Service, and 32% as “Access” in 2007.

NOTE: See Appendix I for comments. We left out “nonregulated” and “Black Hole” revenues, as well as all affiliate revenues and additional expenses, as discussed in other reports.[35]

In 2007, this group of 16 incumbent phone utilities’ Local Service revenues averaged 60% of total revenues while Access revenues were about 40% (counting Special Access).

- The total revenues were $44 billion in 2007 and local service was 60%, or $27.1 billion.
- Access revenues were $16.8 billion and $9.6 billion of that were special access services. (As we previously discussed, Verizon’s special access revenues in New York grew 195% since 2000. And we found that it grew 79% from 2007 to 2015.)

5.2 However, Local Service Paid 72% of Corporate Operations Expense, 71% of ‘Network Costs’.

As we discussed, Verizon NY’s percentage of expenses applied to each revenue category were ‘frozen’ by the FCC in the year 2000, and the outcome was to dump the majority of expenses into Local Service.

We find that this pattern is continuous throughout the US. In this collection of incumbent phone companies for 2007, Corporate Operations was not evenly divided up based on revenues, but was kept at inflated amounts for local service while the ‘access’ and special access services paid a fraction of the expenses.

[35] http://newnetworks.com/verizonny/

America's Incumbent Utilities Revenues, Corporate Operations and "Network Costs," 2007

	Total	Local	Access
Revenue	$ 43,907,318	$ 27,114,043	$ 16,793,277
Corporate Operations	$ 5,008,470	$ 3,604,941	$ 1,403,529
Total "Plant Specific" Costs	$ 8,533,923	$ 6,012,855	$ 2,521,069
Revenue		60%	40%
Corporate Operations		72%	28%
Total "Plant Specific" Costs		71%	29%

5.3 The Corporate Operations Expense was Paid for by Local Phone Customers.

In one of our previous reports we examined the Corporate Operations expense, primarily for Verizon New York, from 2000-2014 and found that by 2014, Local Service was paying 60% of this entire expense. However, in terms of revenues and expenses, Verizon NY's Local Service only brought in $1.4 billion; Corporate Operations expense was $1.6 billion — i.e.; Local Service paid approximately 109% of expense based on the revenues — and it made Local Service look unprofitable.

In this exhibit and chart we sorted this group to detail the range of Corporation Operation expense added to local service expenses.

- Throughout America, on average, in 2007, 70+% of "Corporate Operations" expense had been dumped into local service.
- We note that the access side of the equation paid only 30% of this expense.
- Though it varies by phone company and location, the Verizon California territory (added as part of the GTE merger, which was then sold off to Frontier) dumped a whopping 78% of the Corporate Operations expense into local service (intrastate) category, as did AT&T in Illinois.

America's Utility Dumping of Corporate Operations Expense into Local Service, 2007

	Separations	Local	Access	Special	Local	Access
Verizon-GTE California	$ 258,859	$ 203,080	$ 55,780	$ 11,261	78%	22%
AT&T-Illinois Bell	$ 248,908	$ 193,626	$ 55,283	$ 6,847	78%	22%
AT&T-Ohio Bell	$ 180,067	$ 136,166	$ 43,901	$ 7,572	76%	24%
AT&T-Pacific Bell - California	$ 743,215	$ 559,141	$ 184,074	$ 40,975	75%	25%
Verizon Florida LLC	$ 162,990	$ 122,508	$ 40,482	$ 8,393	75%	25%
Centurylink-Qwest-Colorado	$ 131,869	$ 97,716	$ 34,153	$ 6,049	74%	26%
AT&T-BellSouth-Tennessee	$ 110,541	$ 81,025	$ 29,515	$ 5,167	73%	27%
Verizon-Maryland	$ 239,740	$ 173,268	$ 66,472	$ 18,848	72%	28%
Verizon Pennsylvania	$ 422,168	$ 303,753	$ 118,415	$ 30,877	72%	28%
AT&T-Southwestern - Texas	$ 484,584	$ 348,590	$ 135,994	$ 38,072	72%	28%
Verizon New Jersey	$ 425,805	$ 303,828	$ 121,977	$ 32,832	71%	29%
Centurylink-Qwest-Oregon	$ 58,678	$ 41,835	$ 16,842	$ 3,126	71%	29%
AT&T-Southwestern - Kansas	$ 55,097	$ 39,030	$ 16,067	$ 3,714	71%	29%
Verizon New York Telephone	$ 1,092,744	$ 740,543	$ 352,201	$ 160,833	68%	32%
Verizon NE - Massachusetts	$ 326,090	$ 216,948	$ 109,142	$ 48,820	67%	33%
Verizon Washington D.C.	$ 67,115	$ 43,884	$ 23,231	$ 9,458	65%	35%
Special Access is a Subset of the Total Access				Average	72%	28%
Special vs Total -- % of Special Compared to Total Access.						

FCC ARMIS 2007, New Networks Institute

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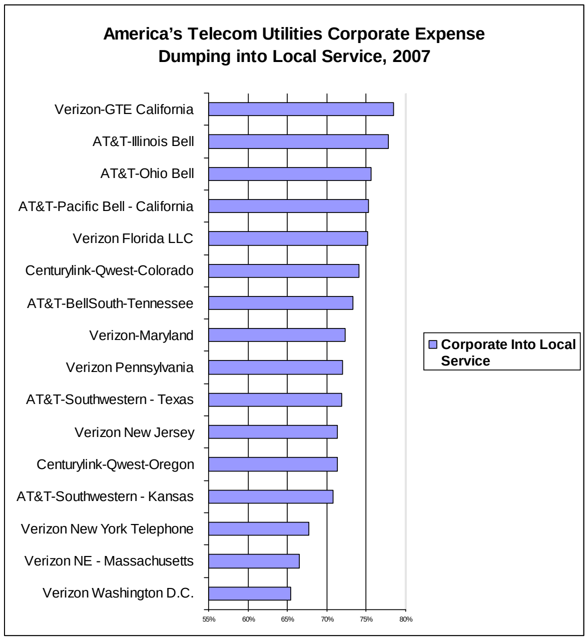

However, another cross-examination revealed that the differential between the expenses dumped into Local Service and those based on access can be enormous.

This next exhibit takes the Corporation Operations expense and asks – what is the ratio of this expense to the revenues?

In 2007, AT&T's Corporate Operations were about 8-9% of revenues overall while Verizon had it at 11- 20%, I.e., in New York, this one expense is 20% of the size of the revenues. But, a closer examination is that the expenses for access may only be 5-7%.

- On the overall corporate expense, Local Service paid 72%, access paid 28%-- thus Local Service is paying 164% more than access.
- In this comparison of the expense relative to the total revenues, Local Service is paying 64% more.

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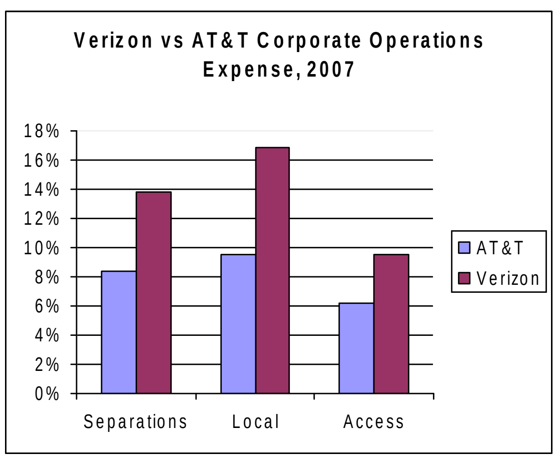
Corporate Operations Expense Compared to Revenue, 2007

	Separations	Local	Access	Difference
AT&T-Illinois Bell	8%	9%	5%	67%
AT&T-Southwestern - Kansas	8%	10%	6%	72%
AT&T-Ohio Bell	9%	11%	6%	73%
AT&T-Pacific Bell - California	9%	10%	6%	64%
AT&T-BellSouth-Tennessee	8%	8%	7%	26%
AT&T-Southwestern - Texas	8%	9%	7%	32%
Centurylink-Qwest-Colorado	7%	10%	4%	122%
Centurylink-Qwest-Oregon	8%	10%	5%	88%
Verizon-GTE California	11%	14%	6%	133%
Verizon Florida LLC	12%	16%	7%	123%
Verizon-Maryland	12%	15%	8%	88%
Verizon NE - Massachusetts	15%	17%	12%	40%
Verizon New Jersey	14%	18%	9%	95%
Verizon New York Telephone	20%	23%	16%	45%
Verizon Pennsylvania	14%	18%	9%	93%
Verizon Washington D.C.	12%	15%	9%	56%
	10%	**13%**	**7%**	**74%**
Overall Corporate Expense		**72%**	**28%**	**163%**

We also noticed that AT&T was assigning less of this expense than Verizon, at least for this sample and for the year 2007. AT&T had assigned expenses equaling about 8% of revenues while Verizon had it at 14%, and in general, Verizon put more expenses in each category. Overall, Verizon put 65% more Corporate Operations expenses into their state-based incumbent utility companies than AT&T, with the majority in Local Service.



Comparing AT&T and Verizon Corporate Operations Expense, 2007

	Separations	Local	Access
AT&T	8%	10%	6%
Verizon	14%	17%	10%
Difference	65%	76%	54%

5.5 Local Service Paid 71% of Networks Costs in 2007

Using the same group of incumbent utility phone companies, the network expenses commonly known as “plant expenses”, were also disproportionately dropped into Local Service, where 71% of expenses ended up in the Local Service financial bucket. And it varies as AT&T in Illinois places 77% of the expenses into Local Service, which means that access and the other lines of business only put in 23%.

America's Incumbent Utilities "Plant" Expenses by "Local" and "Access" 2007

	Separations	Local	Access	Special	Local	Access
AT&T-Illinois Bell	$ 604,351	$ 463,353	$ 140,998	$ 14,584	77%	23%
AT&T-Southwestern - Kansas	$ 112,609	$ 78,898	$ 33,711	$ 8,406	70%	30%
AT&T-Ohio Bell	$ 353,724	$ 263,754	$ 89,970	$ 14,483	75%	25%
AT&T-Pacific Bell - California	$ 1,420,468	$ 1,048,823	$ 371,645	$ 77,101	74%	26%
AT&T-BellSouth-Tennessee	$ 218,630	$ 159,707	$ 58,923	$ 10,592	73%	27%
AT&T-Southwestern - Texas	$ 1,031,852	$ 727,170	$ 304,682	$ 82,392	70%	30%
Centurylink-Qwest-Colorado	$ 283,038	$ 205,190	$ 77,849	$ 17,774	72%	28%
Centurylink-Qwest-Oregon	$ 99,437	$ 70,590	$ 28,847	$ 5,762	71%	29%
Verizon-GTE California	$ 339,022	$ 257,581	$ 81,441	$ 17,346	76%	24%
Verizon Florida LLC	$ 224,390	$ 164,737	$ 59,653	$ 11,271	73%	27%
Verizon-Maryland	$ 327,536	$ 230,318	$ 97,218	$ 26,159	70%	30%
Verizon NE - Massachusetts	$ 560,168	$ 354,851	$ 205,317	$ 96,452	63%	37%
Verizon New Jersey	$ 594,220	$ 413,030	$ 181,189	$ 45,529	70%	30%
Verizon New York Telephone	$ 1,769,210	$ 1,157,099	$ 612,112	$ 286,106	65%	35%
Verizon Pennsylvania	$ 524,473	$ 372,537	$ 151,936	$ 37,663	71%	29%
Verizon Washington D.C.	$ 70,795	$ 45,217	$ 25,578	$ 9,715	64%	36%
Total "Plant Specific" Costs	**$ 8,533,923**	**$ 6,012,855**	**$ 2,521,069**	**$ 761,335**	71%	29%

Sources: FCC ARMIS, 2007, New Networks Institute

Conclusion: It would appear that in every state, the incumbent phone companies, with the active help of the FCC by approving allocation manuals/hearings, passive ambivalence or limited statutory authority of the state commissions, (and the failure of the FCC to audit their own rules), allowed for the disproportionate amount of expenses to be dumped into the local service category, making the local service networks look unprofitable; this has been going on since the year 2001, when the freeze was implemented,

APPENDIX I: NOTES on the Incumbent Selection Process

1) This section of the report is based on the FCC's ARMIS information for the last year it was collected and available, 2007 and it covered the incumbent phone utilities' financial and business practices, including revenues, expenses and profits.
2) We left out 'non-regulated' service category because it was still not a large financial category and our goal is to show that the freeze exists, not explain the minutia.
3) We are not attempting to be comprehensive. That would be impossible as the last data available from the FCC is 2007.
4) Except for New York State, we know of no state that has a requirement for a comprehensive set of financial accounting books, even answering basic questions like total revenues.
5) We selected the incumbents in part through activities happening in a state, but the selection process more random than not – a reflection of specific parts of the US.
   - Kansas and Texas are AT&T states where Google has entered some of the markets,
   - Tennessee is currently the midst of Chattanooga building a fiber network and proceedings at the FCC and courts to stop it in this and other states.
6) There have been filings in almost every Verizon state.
   - Verizon FL and CA have been sold to Frontier,
   - There is a current proceeding in New York pertaining to issues of misallocation filed by Connect NY. It is based in large part, on our filings and research.
   - CWA has filed in almost every east coast state to examine the 'quality of service' and the lack of broadband.

(CONFIDENTIAL)

APPENDIX II
Examination of Verizon New York's financial results, with all of the calculations used to determine the expense allocations, from 2000-2015.

Spreadsheet Available on Request.