EXECUTIVE SUMMARY

Fixing Telecommunications

Report 1: Verizon's Manipulated Financial Accounting & the FCC's Big "Freeze"

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EXECUTIVE SUMMARY: REPORT 1

This is the first report in a new series, "Fixing Telecommunications". It is based on mostly public, but unexamined, information that exposes one of the largest financial accounting scandals in American history. It impacts all wireline and wireless phone, broadband, Internet and even cable TV/video services, and it continues today with impunity.

Verizon, AT&T, CenturyLink, and other large telephone companies have been able to manipulate their financial accounting to make the local phone networks and service look unprofitable and have used this 'fact' in many public policy and regulatory decisions that benefited the incumbent telecommunications utilities.

In NY State, Verizon used this excuse to raise rates multiple times, stopped deploying and upgrading the fiber optic-based wired networks fiber and even stopped maintaining the copper networks with the plan to shut off the copper and force customers onto wireless. This has left most cities with deployment gaps or no upgrades at all.

Worse, it also impacts the price for wireless services, as almost all mobile data, video or calls end up riding over a wire, known as 'special access'. These services are mostly controlled by Verizon, and in their own territories, AT&T and Centurylink (they do not compete among themselves for this business in any significant way).

Adding insult to injury, the losses were caused by the other Verizon lines of business dumping expenses into the state utility. Much of Verizon Wireless's fiber wires to the cell towers were paid for by local phone customer rate increases.

Finally, this impacts every aspect of the FCC's Internet Order, commonly known as Net Neutrality, which is now in court. The massive cross-subsidies between and among Verizon NY and Verizon's other subsidies have allowed the company to control the networks and services over them, including blocking competition —which caused Net Neutrality concerns in the first place.

The FCC's Big Freeze—15 Years of Regulatory Neglect

However, the core of this scandal is so bizarre that no one would believe it if it was detailed in some thriller about financial chicanery. 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.[1] It assigns the majority of all expenses to the local phone service category and there have been no major audits and no examination by

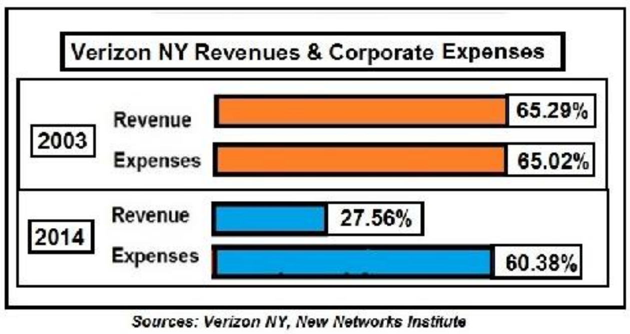
[1] The FCC's most recent order on this: http://apps.fcc.gov/ecfs/document/view?id=7521314401.

either state commissions or the FCC for the last 15 years, even though the FCC has been collecting the information (though stopped making most of it public in 2007).

While this report focuses on Verizon New York (as it is the only state that requires a full annual report that is made public), this problem is national in scope and appears to be impacting every AT&T, Verizon and Centurylink incumbent telephone territory.

EXAMPLE: In 2003, Verizon NY's Local Service brought in 65% of revenues and paid 65% of the "Corporate Operation" expenses. In 2014, Local Service generated only 27.6% of revenues, about $1.4 billion, but it paid the majority of the "Corporate Operation" expense, over 60%, which came to $1.6 billion. We will come back to this in a moment.[2]

EXHIBIT
Verizon NY Revenues & Corporate Expenses, 2003-2014



What We Found: Local Telecommunications Network Costs have been Manipulated.

Verizon tells everyone who will listen that the local telecommunications networks are unprofitable. The local telecommunications networks are the critical infrastructure of the state utility networks that are used to provide basic residential and business, mostly copper-wire-based phone service, as well as the ancillary add-on services from Caller ID to nonlisted numbers.

However, as mentioned, these telecommunications networks are also the networks that provide all other fiber or copper-wired services, from 'special access' broadband and data services used by businesses to the wires that connect to the cell sites. Even the fiber optic wires that are used to offer FiOS services are part of this network. The telephone companies are not required to – and do not – maintain "duplicate" networks.

[2] This report relies on primary documents, including Verizon New York's Annual Reports filed with the NY Public Service Commission. This exhibit uses the 2003 and 2014 reports.

We agree that there has been a decline in local phone service revenues and this is due to a decline of business and residential basic (POTS-"Plain Old Telephone Service") customers. However, two things must be stressed. First, it is clear that part of the decline in revenues was driven by a concerted effort to 'harvest' customers, i.e. force utility customers onto other Verizon services through continuous rate increases. In fact, the price for Local Service should have been in steep decline based on the actual costs to offer the service, among other factors. Second, there has not only been a migration by customers to other Verizon services, such as Verizon's FiOS, but virtually all of Verizon's other services are not included in any accounting of access lines or revenues, especially the special access broadband and data access lines for businesses, which has had massive increases.

In fact, every statistic presented by Verizon on 'access lines' only represents a subset of total lines and only counts one service, POTS. Based on the FCC's last data from 2007, POTS only represented approximately 18% of actual lines in service; with the growth of special access and the decline of POTS, we estimate that today, POTS only represents 4% of access lines (and access line equivalents) in service in 2015.

The Manipulation of Expenses Made Local Service Look Unprofitable.

Verizon's "Local Service" financial accounting category is primarily the copper-based residential and business phone service (POTS). It also includes the revenues from some add-on services, like Caller ID and nonlisted numbers.

This next exhibit is taken from Verizon NY's 2014 Annual Report (which was required to be filed by the New York State Public Service Commission (NYPSC)). The first column lists 'Operating Revenues' and some of the major 'Operating Expense' categories that are charged to Local Service. They include "Network Costs", which are the network construction budgets for upgrades and maintenance (also known as "Plant and Non-Specific Plant"), "Marketing", which includes advertising, and "Corporate Operations", which can include everything from lobbying to lawyers.

The column marked "% Local" is the percentage of the expenses charged to the Local Service financial category in 2014 as compared to the other lines of business that also use the networks, which we will discuss shortly.

According to this, Verizon's Local Service had $1.44 billion of revenues but lost a whopping $2.8 billion in just the year 2014.

EXHIBIT
Verizon NY Local Service Revenues and Expenses, 2014
(In the Millions)

Operating Revenues	**Total**	**Local**	**% Local**
Total Operating Revenues	**$5,230**	**$1,442**	**27.60%**
Total Operating Expenses	**$7,810**	**$4,257**	**54.50%**
Losses		**($2,815)**	

(Sources: Verizon NY, New Networks Institute)

Verizon NY Major Expenses Charged to Local Service, 2014
(In the Millions)

Operating Expenses	**Total**	**Local**	**% Local**
Network Costs	$3,300	$1,526	**46.30%**
Marketing	$342	$180	**52.60%**
Customer Operations	$405	$275	**68.00%**
Corporate Operations	$2,604	$1,572	**60.40%**
Average Local Expense			**57%**

Something is Very Wrong.

- Local Service paid $1.57 billion — 60% of the total expenses charged to Verizon NY for Corporate Operations — but it only brought in $1.44 billion in total revenue.
- Local Service also paid $1.53 billion in network construction and maintenance, almost half of all expenses, 46.3%- almost double the revenues brought in.
- Local Service paid 57% of all major expenses, but only generated 27.6% of the revenues.

Of course, we have to ask – why, exactly, is Local Service paying 60% of the Corporate Operations expense or 46% of all construction and maintenance costs?

This has been going on for over a decade. This next exhibit shows the percentage of Corporation Operations expenses dumped into Local Service starting in 2003 through 2014.[4]

[4] We use the year 2003 because the Verizon New York 2003 annual report was public, but 2004-2008 are not available.

EXHIBIT
Verizon NY Local Service Corporate Operations Expense, 2003-2014

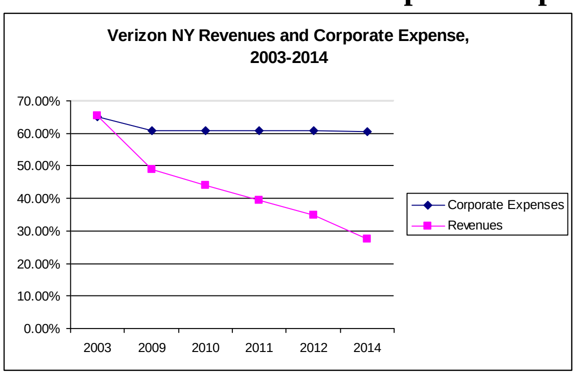
	Corporate Expenses	Revenues
2003	65.00%	65.3%
2009	60.70%	49.0%
2010	60.80%	44.1%
2011	60.80%	39.4%
2012	60.70%	34.9%
2014	60.40%	27.6%

Sources: Verizon NY, New Networks Institute

In every year, Verizon NY's Local Service not only paid the majority of corporate expense, 60+%, but it has essentially been 'frozen'- i.e., fixed as a specific percentage of the total expense, regardless of what the revenues were.

In 2003, revenues were 65.3% of the total revenues in Verizon New York and the expenses were 65%, yet by 2014 revenues are just 27.6%, but the expense for Corporate Operations was 60%, little change from 2003.

EXHIBIT
Verizon NY Local Service Revenues & Corporate Expense, 2003-2014



How Much Money Are We Talking About? Billions Per Year in Just New York.

To give the reader a stark, clear example of just how out of whack this is, if we take the first example of expenses for the year 2014 and simply readjust the expenses to match the revenues, the Local Service category would have paid $2.1 billion less in expenses and every category would have changed. Instead of network costs at $1.5 billion, for example, it would be $911 million; thus Local Service would not be made unprofitable by this one expense.

If just the four categories — network costs, marketing, customer operation and corporate operations were adjusted to be based on revenues, then Local Service was overcharged about $1.7 billion in just 2014. Meanwhile, again, the total expenses for Local Service would drop $2.1 billion.

EXHIBIT
Verizon NY Local Service Revenues and Expenses, Adjusted, 2014
(In the Millions)

	Local	% Local	Adjusted	% Rev	Difference
Operating Revenues					
Total Operating Revenues	$ 1,442	**27.6%**	$ 1,442	27.6%	
Operating Expenses				27.6%	
Network Costs	$ 1,526	**46.3%**	$ 911	27.6%	$ 615
Marketing	$ 180	**52.6%**	$ 94	27.6%	$ 86
Customer Operations	$ 275	**68.0%**	$ 112	27.6%	$ 163
Corporate Operations	$ 1,572	**60.4%**	$ 719	27.6%	$ 853
					$ 1,717
Total Operating Expenses	$ 4,257	**54.5%**	$ 2,156	27.6%	$2,101
Losses	$(2,815)		$(714)		

Sources: Verizon NY, New Networks Institute

If Verizon Stopped Fixing the Copper, How Did It Charge Local Service $1.5 Billion for Network Construction and Maintenance?

While this still shows an overall loss for Local Service even when expenses are allocated by revenue, there is a much deeper issue. Why is Local Service being charged $1.5 billion (or $911 million after reallocation) in network costs? Verizon NY is not upgrading and maintaining the copper networks. So, even if the construction and maintenance budgets were based on the percentage of revenues, it is much more than what is actually being spent for Local Service.

Verizon has stated to the FCC that:

> "Since 2008, Verizon has spent more than $200 million on its copper network."[5]

[5] http://apps.fcc.gov/ecfs/document/view?id=60001115777

This Verizon statement represented ALL of the Verizon territories, which included their entire East Coast holdings, from Massachusetts to Virginia. While Verizon's filings added caveats that there were additional copper network expenses (which Verizon never supplied any more information about), even if Verizon spent $200 million a year in New York alone, this would only represent 13% of what was charged to Verizon NY Local Service in 2014.

In examining the 'minutiae' of every category, it is clear that in every financial bucket there are hundreds of millions of dollars in expenses that have nothing to do with offering local service, but have been dumped into the costs.

For example, Local Service represents the copper-based, basic phone service — Why is there a $179 million charge for marketing costs? — When was the last time you saw an advertisement for basic phone service? It is almost impossible to find information about this service, even on the Verizon web site. There has been little or no advertising or marketing for basic service for at least a decade.

These expenses, if not from Local Service, must be paying for something else. In fact, there are massive cross-subsidies going on where Local Service is paying the majority of expenses and is subsidizing Verizon's other lines of business. Verizon New York has revenues coming in from FiOS services, as well as "Access & Special Access" fees (which are broadband and data services for business, or wholesale 'backhaul' services used for wireless networks), and "Nonregulated" revenues (which are items that were moved out of Local Service when they became deregulated, or were never regulated). These service categories use the same state-based utility networks, yet they are paying a fraction of the expenses that Local Service is paying.

There are Many Impacts on Customers and Cities.

Claiming that the wired networks are 'unprofitable', Verizon New York has been able to manipulate public policy and regulatory decisions in their favor.

Multiple Phone Rate Increases:

- Verizon NY local phone rates went up 84%, starting in 2006, based on 'losses'.
- Residential and small business local phone customers paid about $996 extra, counting taxes, fees and surcharges, since 2006, for just basic service.
- Add-on features went up 50%-300%. From unpublished numbers to inside wire maintenance, almost every service was charged hundreds of dollars extra.

On the Revenue Side, Since 2006:

- Verizon brought in over $4.3 billion extra on just basic local service. Adding the increases to just one add-on charge brought the total to $5.6 billion (counting taxes). These are the low estimates.

Massive Losses

- Verizon NY claimed losses of $2.6 billion in 2014 with an “income tax benefit” of $1.3 billion.
- Starting in 2009, Verizon NY showed losses with an average of $2.3 billion per year and a resulting ‘income tax benefit’ of $1.1 billion.
- **Paid No Income Taxes**: Based on the annual reports, Verizon NY did not pay state or federal income taxes for over a decade.

Paid for Fiber Optic Build Outs: The multiple rate increases were granted based on “losses” as well as “massive deployment of fiber optics”.

80% of NY Municipalities are Not being Served by Verizon NY's FiOS

- **No Upgrades**: Verizon stopped building the fiber optic networks in 2011/2012 and left 900+ upstate NY cities lacking and others incomplete, including NYC.

Estimated Coverage for Fiber Optics in NY State- 45-65% of “Locations”

- While Verizon claims to have completed the FiOS fiber optic deployment of New York City (which was supposed to have 100% completed by 2014), an audit by New York City found major gaps in deployment.
- Based on Verizon’s own announcements (cross-referenced with Census and FCC information), Verizon has only 45%-65% coverage in NY State (or NYC), depending on which metric is used.

Massive Cross-Subsidies

- Verizon NY local phone customers paid the majority of the construction expenses, which were diverted to fund other lines of business, such as the wires to the cell towers for Verizon Wireless.
- Verizon NY Local Service was charged 60% of the corporate operations expenses, paying $1.6 billion —109% above the total revenues of local service.

How much are we talking about? Billions per year, per state in added expenses

- In New York, Verizon’s Local Service was over-expensed by $2.1 billion for 2014 alone. On a national basis, this would be around $24 billion annually.
- This doesn’t account for rate increases paid or inflated pricing or the economic harms incurred.

The Big Freeze: 15 Years of Scandal and Customer Overcharging

This report focuses on a core finding: these machinations have been done to make local service look unprofitable. And at the core is the bizarre “freezing” of the percentage of expenses to match the calendar year 2000.

To recap, in the year 2001, the FCC ‘froze’ the percentage of expenses that almost all wired services pay, based on the year 2000. So, in 2003, for example, Local Service paid 60% of all expenses, and in 2014 it paid an identical amount, even though the revenues for local service were in steep decline. The expenses frozen include virtually all of the costs of maintaining and upgrading the networks, corporate operation expenses and marketing.

The FCC Froze Future Expense Allocations Based on the Year 2000.

Note: "Intrastate" are services within the state, such as local service — "Interstate" are services that cross state lines (or that the FCC has deemed to be under their jurisdiction). The FCC writes,[6]

> "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."

And when we use the term "freeze", we are actually quoting the FCC.

> "Freezing of jurisdictional separations category relationships and/or allocation factors
> (a) Effective July 1, 2001, through June 30, 2017, all local exchange carriers…shall apportion costs to the jurisdictions using their study area and/or exchange specific jurisdictional allocation factors calculated during the twelve month period ending December 31, 2000, for each of the categories/sub-categories as specified herein."

So literally, the FCC 'froze' the expenses based on the year 2000. This is the current model used in every state in America.

The Manipulation of Public Policy

What we uncovered, then, is a massive and systemic ability to use Local Service as a dumping ground for expenses to make Local Service, as well as the local networks, look unprofitable. This manipulated and corrupted mathematics is combined with other regulatory and deceptive machinations (that we discuss in other reports), that all help Verizon (and the other phone companies) fulfill many of Verizon's policy goals that are good for Verizon but bad for customers and New York State — or the country.

[6] See 2014 order, http://apps.fcc.gov/ecfs/document/view?id=7521314401

The FCC Big Freeze Happened in Every Verizon State and in Every AT&T and CenturyLink State.

We dedicated one report in this series to demonstrate that the FCC's Big Freeze is a national problem. In this next exhibit we examine a group of AT&T, Verizon and Centurylink incumbent utility holdings and detail the range of Corporation Operation expense added to Local Service expenses for the year 2007— the last year the FCC collected and made public this information. Throughout America, on average, in 2007, 72+% of "Corporate Operations" expense had been dumped into Local Service, while only 28% was placed into "Access" costs, which includes the revenues and expenses for special access.

EXHIBIT

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	$ 240,908	$ 193,626	$ 55,203	$ 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	$ 40,402	$ 8,393	75%	25%
Centurylink-Qwest-Colorado	$ 131,869	$ 97,716	$ 34,153	$ 6,640	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

The Manipulation of Expenses Impacts Every FCC Proceeding where "Local Service" has been Deemed "Unprofitable".

There are a slew of current state and federal proceedings that this manipulated financial accounting impacts today. From the IP Transition to the "migration" from the copper networks or the shutting off of those networks, or the claim that the companies can't upgrade cities because it is 'unprofitable', or increases to prices of broadband and data services to every business (including special access) — there has been a massive, nationwide shell game as this has happened in every state in America and impacts every city in America. In short:

- Price increases on local service that were based on 'losses'— were manipulated.
- Losses that were used to not pay state or federal income tax — are in question.
- Not building out the networks because they were 'unprofitable' — is based on manipulated financial accounting.

And, as we discuss in other reports, there are a host of other related actions being taken that are helped by this total lack of regulatory oversight and the manipulation of the financial accounting.

- Local phone customers paid for building out the wireless networks as well as the special access networks.
- The price of even wireless service is based on the cost associated with special access and tied to the costs of local service networks.
- The price for competitors to use the networks has been manipulated.
- Verizon's own affiliate companies get perks no other competitor receives, including not paying market prices.

The Following Reports are Slated for Fixing Telecommunications, 2015-2016:

- Report 1: Verizon's Manipulated Financial Accounting & the FCC's Big "Freeze"
- Report 2: Data Report on Verizon New York's Financial Accounting.
- Report 3: The FCC's 15 Year Big Freeze
- SPECIAL Report 4: The FCC's Big Freeze: A Nationwide, Financial Accounting Scandal involving AT&T, Verizon and CenturyLink, in Every State.
- Report 5: Special Access: Revenues, Access Line Accounting & Cross-Subsidies.
- Report 6: Reverse Engineering Verizon's Expenses: Regulatory and Legal Challenges on Prices, Special Access and Fiber Optic Deployment.
- Report 7: Wireline-Wireless Cross-Subsidies and 'The Takeover'.
- Report 8: Follow the Money: Tracking the Revenues from Communications Bills and Business Services.
- Report 9: Getting America's Municipalities Upgraded
- Report 10: Miss-Allocation & the IP Transition, Copper Migration, Net Neutrality

Brief History of the Previous Reports

This six-year project includes three previous reports that have been dedicated to exploring Verizon's financials and the flows of money between the other Verizon subsidiaries.

- **2012 — "Verizon's State-Based Financial Issues & Tax Losses: The Destruction of America's Telecommunications Utilities",** covered five Verizon states including New York, New Jersey, Pennsylvania, Massachusetts and Rhode Island, (Verizon New England)

- **2013 — "Verizon Wireless and the Other Verizon Affiliate Companies Are Harming Verizon New York"**, with assistance from Alexander Goldman, Esq.

- This 2013 report was used by Common Cause, CWA, Consumer Union, AARP and Fire Island Association as part of comments filed with the NYPSC questioning the misallocation of monies.

- **2014 — "It's All Interconnected",** published by Public Utility Law Project, PULP, with the assistance of David Bergmann, Esq.
- **2014 —**The **Connect New York Coalition** (Common Cause, CWA, Consumer Union, et al) filed a Petition at the NY Public Service Commission calling for an investigation of 'misallocation' of monies, based on our previous reports.

- **CURRENT 2015 —** The NYPSC has an open proceeding to examine the Connect NY Coalition's Petition, Case Matter 14-C-0370.

About New Networks Institute — Established in 1992, NNI is now an independent team of experts, analysts, auditors and lawyers working on projects in the Public Interest.

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