VERIZON DIRECT CASE

WC DOCKET NO. 02-317

EXHIBIT A

EXHIBIT A

Subject: Basis for Requiring a Deposit or Advance Payments from a Customer

Issue 1: Discuss whether the revised security deposit and advance payment provisions applicable to interstate access customers, both new and existing, are reasonable and not so vague as to permit Verizon to discriminate unreasonably among its interstate access customers, whether they be interexchange carriers, competitive LECs, or business end-user subscribers. (Designation Order, ¶ 11) Are Verizon's provisions sufficiently clear and unambiguous to preclude discriminatory or anticompetitive application? (Designation Order, ¶ 17)

Response:

The criteria for requiring a security deposit or advance payments are concrete and relate directly to situations that would imperil Verizon's ability to get paid. Therefore, it is reasonable to require "adequate assurances" of payment in these situations. The criteria Verizon has established for requiring a deposit are similar to – or even more limited than – the criteria set forth in other carriers' tariffs. *See* Reply Comments of Verizon, Transmittal No. 226, Exhibit C, at 1 (filed Aug. 7, 2002). Because other carriers already routinely have such provisions in their tariffs, this is strong evidence of their reasonableness. In addition, the tariffs are based on specific criteria that are reasonable and not vague on their own terms. In fact, they are even more specific than the conditions under which Verizon can request a security deposit pursuant to the current tariff. The revised tariffs provide that a security deposit (cash or letter of credit) or advance payments may be required only if one or more specific, objectively defined events occur:

History of late payment. The tariff revisions state that Verizon may require a security deposit or advance payment if (1) a customer's account balance has fallen in arrears in any two months out of any consecutive twelve-month period; or (2) the customer owes $250,000 or more to Verizon that is 30 days or more past due. Not only are these provisions objectively defined on their own terms, but they are simply specific iterations of *existing* tariff provisions which *already* allow Verizon to require a security deposit from a customer "which has a proven history of late payments to the Telephone Company." Verizon Tariff FCC No. 1, § 2.4.1(A). As far back as 1984, the Commission approved this tariff language for use by all former Bell Operating Companies ("BOCs") in their access tariffs.[1] Because these criteria merely clarify situations in which Verizon may exercise existing rights pursuant to the tariff, and the existing provisions have been expressly approved by the Commission, these provisions regarding late payment are necessarily just and reasonable. Moreover, even absent past Commission approval, it is reasonable to assume that customers who have not paid Verizon in the past are more likely than the general customer base to not pay future bills.

Objective indicia of insolvency. The revised tariffs also state that Verizon may require a security deposit or advance payment if, (1) the customer or its parent "informs [Verizon] or publicly states that it is unable to pay its debts as such debts become due"; or (2) the customer or its parent has initiated a voluntary receivership or bankruptcy proceeding, or if such a proceeding has been initiated against the customer or its parent. *See* Verizon Tariff FCC No. 1, § 2.4.1(A)(2). Again, these triggers are defined based on specific, objective criteria, and thus cannot be called "vague." If a customer is in bankruptcy or receivership, or states that it is unable to pay its debts as they become due, there is a reasonable question as to that customer's continuing ability to pay future bills.

[1] *See Investigation of Access and Divestiture-Related Tariffs*, Memorandum Opinion and Order, 97 FCC 2d 1082, Appendix D, at discussion of Section 2.4.1(A) (1984) ("1984 Order").

Under such circumstances, it is reasonable for a supplier who is providing services to request adequate assurance of future payment before it provides future services for which it may not be paid.

Credit ratings at or near "junk" status. The final criteria for requiring a security deposit or advance payment are if (1) the senior debt securities of a customer or its parent are below investment grade (also known as "junk"); or (2) the senior debt securities of a customer or its parent are rated at the lowest investment grade rating category by a nationally recognized statistical rating organization, and are put on review for a possible downgrade. *See* Verizon Tariff FCC No. 1, § 2.4.1(A)(2). The definition of "investment grade" is one that is objectively defined, and even used in federal securities regulations. *See, e.g.*, 17 CFR § 240.3a1-1(b)(3)(v). As described more fully in section I.A.2 of the Direct Case brief, it is reasonable to undertake precautions against nonpayment when a company or its parent's securities fall below investment grade (or are at imminent risk of falling below investment grade), because it is well established that "[c]redit ratings provide objective, consistent and simple measures of creditworthiness" and are regarded as "a key measure of a company's financial health."[2] Indeed, private contracts often use downgrades in investment ratings as triggers for requiring adequate assurance.[3]

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[2] Moody's Investor Service, Rating Policy, "Understanding Moody's Corporate Bond Ratings and Rating Process," at 5 (May 2002) *available at* www.moodys.com/moodys/cust/ratingdefinitions/rdef.asp; BusinessWeek Online, "The Credit-Raters: How They Work and How They Might Work Better," (April 8, 2002), *available at* www.businessweek.com/magazine/content/02_14/b3777054.htm.

[3] *See* Moody's Investor Service, Rating Policy, "Understanding Moody's Corporate Bond Ratings and Rating Process," at 6 (May 2002) ("Investors and counterparties embed ratings as triggers into private contracts in order to protect themselves from potential deterioration in the creditworthiness of an obligor's financial position"). *See also* Jonathan Stempel, Issuer in the News, "Moody's, S&P Say Demanding More Disclosure on Risks," Feb. 6, 2002, *available at*

The proposed tariff revisions state that Verizon "may" require a security deposit and, if it "elects" may require payment in advance in lieu of a deposit. Verizon FCC Tariff No. 1, §§ 2.4.1(A)(2) and (3). The Designation Order states that "[t]he terms 'may' and 'elects' give Verizon considerable discretion to enforce these provisions" and has expressed concern that "[w]ithout definitive criteria in the tariff, what would prevent Verizon from collecting a security deposit or advance payment from one customer and nothing from another when both meet one of the criteria for security deposits or advance payments?" Designation Order, ¶ 19. The Bureau has asked that Verizon "explain how these tariff provisions can be applied in a non-discriminatory manner." *Id.* As an initial matter, the tariffs do not grant Verizon unlimited discretion regarding security deposits or advance payments – it can require such payment assurances *only* if a customer has presented objective evidence of lack of creditworthiness. Moreover, there is simply no incentive for Verizon to apply these provisions in a "discriminatory" manner. In fact, there are disincentives to require a deposit or advance payments unless Verizon believes they are absolutely necessary to protect against the risk of customer bad debt. Pursuant to the tariffs, Verizon must pay significant interest of 18.25% to the customer on security deposits. And advance payment calculations must be performed manually, and updated periodically, at considerable cost and burden to Verizon.

The discretion that is built into the tariffs is designed to benefit *customers*, not Verizon. For example, rather than having a provision that mandated that Verizon require a security deposit or advance payment whenever one of the triggers was satisfied, the

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www.markets.reuters.com/cabonds/Editorial/IssuerInTheNews/IssuerInTheNews898.htm (noting that companies' contracts often have clauses requiring that they pay off their debt or pay a higher interest rates in the event of an investment downgrade).

current provisions would allow Verizon to work with the customer to determine whether such assurances were needed, or if alternative arrangements could be negotiated. Such "discretion" is similar to the type that Verizon's tariffs already can – and should – provide in dealing with financially troubled customers. For example, Section 2.1.8(A) states that if a customer fails to comply with certain tariff provisions, including payment provisions, Verizon "may" refuse additional applications of service, and/or refuse to complete pending orders for service. *See* Verizon Tariff FCC No. 1, § 2.1.8(A). Similarly, Verizon "may" discontinue service if the customer fails to meet certain criteria, such as failure to pay. *Id.* § 2.1.8(B). If it is reasonable for Verizon's tariffs to allow the company discretion in determining whether to refuse to process applications for service, or to discontinue service altogether, it should also be reasonable for Verizon to exercise the same discretion when deciding to undertake the lesser remedy of requesting adequate assurance of payment. Moreover, it is hard to believe that the alternative to "discretion" – *i.e.*, requiring that Verizon *must* demand a security deposit or advance payment when customers satisfy objective criteria – would be something that the carriers objecting to these tariff provisions would actually want.

Issue 2: Verizon shall explain why it believes its rates under price caps do not adequately compensate it for the risk of uncollectibles. (Designation Order, ¶ 12)

Response:

As an initial matter, this question is based on a faulty premise; namely, it seems to assume that so long as Verizon is able to recover some or all of its expenses related to carrier bad debt, it should be precluded from amending its tariffs to try to prevent such bad debt from occurring. That simply cannot be the case. Unlike other companies, Verizon cannot simply refuse to serve those customers that have questionable financial abilities to pay. Verizon should not be required to continue to serve customers that may not pay, and either absorb the cost of other carriers' financial failures, or pass those costs on to its customers in the form of higher rates. Rather, if a carrier presents objective evidence that its creditworthiness is questionable, Verizon – like any other business – should be able to require an adequate assurance of payment.

Moreover, current costs due to extraordinary carrier uncollectibles are *not* already included in the price cap rates. Before price cap regulation, incumbent local exchange carriers ("ILECs") such as Verizon developed rates based on revenue requirements. Thus, figures reported in ILECs' 1990 rate of return filing were used in setting the initial price cap rates in 1991. Although rate of return and price cap access rates have historically included an embedded calculation of expected uncollectibles, the uncollectible figures used to set initial rates are extremely out of date, represent an uncollectible amount that has not kept pace with the changing nature of the telecommunications marketplace, and do not sufficiently account for Verizon's costs due to the extraordinary growth in carrier bad debt.

For the last interstate annual revenue requirements filings in 1990 and the first price cap filings in 1991 (as well as throughout most of the 1990s), the uncollectible levels were far lower than they are today – both in absolute numbers and as a percentage of overall revenues. Verizon's predecessors' last rate of return filings with the Commission, filed on July 1, 1990, included **{BEGIN PROPRIETARY}** **{END PROPRIETARY}** in interstate revenue requirements for the Verizon-East, and **{BEGIN PROPRIETARY}** **{END PROPRIETARY}** in uncollectibles attributable to interstate for Verizon-West. By contrast, Verizon's reported interstate uncollectibles for 2001 were $110.3 million for Verizon-East and $18.96 million for Verizon-West. *See* Exhibit A-1 (data are adjusted from ARMIS for the sale of exchanges to be comparable to 1990). Thus, in the last decade, interstate uncollectibles increased a whopping 445% and 375% in the East and West respectively. By comparison, interstate access revenues grew only approximately 35% in the East and 65% in the West during the same time period.

In addition, carrier uncollectibles have been growing far more rapidly than end user uncollectibles. Because end users represent a cross-section of the economy, while carriers are unique to the telecommunications industry, this disparity demonstrates that the growth in interstate uncollectibles is a result of factors unique to the telecommunications industry. Indeed, based on internal calculations, Verizon has estimated that, while end-user uncollectibles for Verizon-East grew approximately **{BEGIN PROPRIETARY}** **{END PROPRIETARY}** between 1990/91 and 2001, during the same time period carrier uncollectibles for Verizon-East increased **{BEGIN PROPRIETARY}** **{END PROPRIETARY}.**

During the early 1990s, when the rate-of-return and early price cap filings were being made, there were different relationships between the carrier customers and the LECs as the access suppliers. At that time, the overwhelming amount of uncollectibles experienced by LECs was associated with end user customers, rather than with carriers. In 1996, for instance, only around 2% of Verizon's total uncollectibles for interstate and intrastate revenues were attributable to uncollectible carrier revenues (as opposed to uncollectible end user revenues).[4] However, in 1999, carrier uncollectibles accounted for more than 12% of total uncollectibles. By 2000, that percent had grown to more than 15%. And in 2001, roughly 30% of total uncollectible revenues were due to carrier uncollectibles.

There are no longer only a handful of access carriers as there were when price cap regulation was initiated. Indeed, Verizon is dealing with more carrier *bankruptcies* now than it had carrier *customers* at the inception of price caps. There are hundreds of carriers and end users purchasing access services from the Verizon access tariffs. And, as countless industry analysts and the Commission itself has noted, the telecommunications industry is in "utter crisis" that far outpaces the slowdown in the general economy.[5] The proposed tariff revisions cannot solve that problem by themselves, but they will help to restore a balance in the LEC–customer relationship that has eroded substantially since price caps was initiated.

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[4] For purposes of this discussion, carrier uncollectible and receivable figures include access charges as well as uncollectibles and receivables from unbundled network elements ("UNEs") and resale.

[5] *See, e.g.*, Yochi J. Dreazen, *FCC's Powell Says Telecom "Crisis" May Allow a Bell to Buy WorldCom*, Wall St. J., July 15, 2002, at A1; Moody's Investor Service, Special Comment, *Corporate Defaults Refuse to Yield in 2002*, at 4 (July 2002) *available at* http://riskcalc.moodysrms.com/us/research/defrate/Q202_comment.pdf.

Issue 3: Submit the level of uncollectible debts from interstate access services for 1990-present, and indicate level of interstate uncollectibles included in initial price cap rates. Address whether the variation in uncollectible levels for 2000 and 2001 is merely a normal fluctuation in uncollectibles, which would be covered by the business risks anticipated to be endogenous to price caps, or whether it reflects some long term trend that warrants expanded security deposits and advance payments from customers meeting Verizon's proposed standards. (Designation Order, ¶ 12)

Response:

The data regarding total interstate uncollectibles from 1990 to 2001 is attached at Exhibit A-1.[6] As demonstrated in that exhibit, the uncollectible trend data for 2000, 2001 and thus far for 2002 are not part of a normal fluctuation. In the last decade, interstate uncollectibles increased an incredible 445% and 375% in the East and West respectively during a time when interstate access revenues grew only approximately 35% in the East and 65% in the West. In addition, carrier uncollectibles have been growing far more rapidly than end user uncollectibles, which demonstrates that the growth in interstate uncollectibles is a result of factors unique to the telecommunications industry. Indeed, based on internal calculations, Verizon has estimated that, while end-user uncollectibles for Verizon-East grew approximately **{BEGIN PROPRIETARY}** **{END PROPRIETARY}** between 1990/91 and 2001, during the same time period carrier uncollectibles for Verizon-East increased **{BEGIN PROPRIETARY}**

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The customer base has changed and the business plans of the access customers have changed. The existing access tariffs were designed in the period where Verizon and

[6] The interstate/intrastate split between uncollectibles is not currently available for 2002. In addition, Verizon does not account for uncollectibles by type of service; therefore, it does not have available just the portion of uncollectibles associated with "interstate access services." However, the vast majority of interstate revenues and uncollectibles are related to access services. For example, Verizon has calculated that 90% of interstate revenues are attributable to access services.

other access providers were under rate of return regulation, and different relationships among the carrier customers and the access suppliers, the LECs. The proposed deposit tariff changes attempt to put VZ on a more current – and appropriate commercial basis.

Exhibit A-1 also shows that the level of uncollectibles experienced in recent years has indeed been extraordinary. For example, uncollectibles grew from a total of approximately $27 million in 1990, the year upon which price cap rates were based, to more than $129 million in 2001.[7] Verizon-East uncollectibles of $110 million for 2001 are a 290% increase over the uncollectibles from the prior year alone. These tariff proposals will provide the controls needed to reduce the access uncollectibles to a more "normal" level.

And again, the Designation Order's question about whether this trend is "merely a normal fluctuation in uncollectibles, which would be covered by the business risks anticipated to be endogenous to price caps," Designation Order ¶ 12, simply misses the mark. As an initial matter, even if this trend were not extraordinary and merely reflected part of normal "business risks," the adjustment set in price cap rates assumes that ILECs will be facing the same "business risks" as the rest of the general economy. In setting up the price cap regime, the Commission found that the goals of the Communications Act "generally will best be accomplished by replicating the effects of competition. Therefore, in the absence of clear and substantial evidence that some other regulatory approach will better accomplish the purposes of the Act, we expect to pursue the goal of amending the features of the LEC price cap plan so that it replicates the competitive outcome as closely

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[7] As noted in the notes to Exhibit A-1, these numbers have been adjusted from ARMIS totals to remove COSAs that were not present in all reporting periods, in order to present a consistent picture of the uncollectible trend.

as practicable."[8] Although it may be part of a normal "business risk" to be faced with some customers who may not pay, non-regulated companies and non-ILEC carriers can (and do) institute protections against these risks. For example, they can refuse to do business with those customers, or require security deposits and advance payments.[9] To the extent that Commission policy requires Verizon and other ILECs to face the same risks without allowing it to adopt similar protections, such a policy *in itself* assures that the uncollectible problem is one that is exogenous to the normal "business risks" faced by other companies.

Issue 4: Provide the total amount uncollected, by year, from January 2000 to July 31, 2002. Provide the totals of each of individual defaults grouped into specified ranges (less than $250,000; $250,001-$500,000; $500,001-$1,000,000; $1,000,001-$5,000,000; and more than $5,000,000). For each range indicate the number of defaulting entities. Also indicate total dollar amount of security deposits held attributable to interstate access services and percentage relationship of that amount to average monthly interstate billings. (Designation Order, ¶ 12).

Response:

Verizon does not account for its uncollectibles by type of service; therefore, it does not have available just the "access" service portion of uncollectibles associated with these tariffs. However, the vast majority of interstate revenues and uncollectibles are

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8 *Price Cap Performance Review for Local Exchange Carriers*, First Report and Order, 10 FCC Rcd 8961, ¶ 93 (1995).

9 *See, e.g.,* Robert P. Simons, *The Eye of the Storm: Strategies to Deal With Distressed Companies*, The Legal Intelligencer, Vol. 226, No. 55 (Mar. 21, 2002) (stating that "the Uniform Commercial Code Article 2 provides numerous remedies to the sellers of goods, including the ability to stop the shipment of goods in transit; require the buyer to pay cash in advance or cash on delivery; and the ability to reclaim goods already delivered"); Tanya Irwin and Andrew McMains, *Kmart to Launch "Real Life" Ads*, Adweek Magazines Newswire (Jan. 28, 2002) (reporting that "it is likely that the retailer will be asked to pay for media upfront"); Kevin Maney and Andrew Backover, *WorldCom Drops Bomb on Telecom*, USA Today (July 23, 2002) (noting that vendors "have begun to demand cash payments up front"); Jeffry Bartash, *WorldCom files for Chapter 11* (July 21, 2002) (noting that "nervous WorldCom suppliers have demanded upfront payment").

related to access services. For example, Verizon has calculated that roughly 90% of interstate revenues are attributable to access services. For the data regarding the levels of *total interstate* uncollectibles from 1990 to 2001, see attached Exhibit A-1. In addition, the interstate/intrastate split between uncollectibles is not currently available for 2002. For *total overall* (state and interstate) uncollectibles, from January 2000 to July 31, 2002, see Exhibit A-2, attached.

It is unclear what the Designation Order is referring to by "individual defaults." Verizon does not use a standard definition of "default" in the course of its business, and the term is subject to conflicting interpretations. For example, there are customers with outstanding receivables that are past due, but it is unclear what portion of those outstanding receivables will ultimately be determined uncollectible.

For purposes of this question, for carrier access customers Verizon has created a list of the number of carriers that have been issued "embargo notices" since March 2002. *See* attached Exhibit A-3. These notices were sent for any outstanding access balances, interstate or intrastate. An "embargo notice" notifies a customer that if it does not pay outstanding balances due, Verizon will refuse all applications and service orders for any services and facilities not already in service. It typically is not sent until a customer's outstanding balance is ninety days or more past due. This list reflects information only as of March 2002 and later because Verizon did not begin tracking this information before that time period. The list shows the amount of the customer's outstanding balance, grouped by ranges, as of the current date. In order to protect customer privacy, customers have not been identified by name. As stated above, there are many carrier customers with outstanding balances that are past due that are not included on this list. However, it is impossible to ascertain with certainty what percent of these outstanding balances will ultimately be determined uncollectible.

For the carriers ordering access services, the total average currently monthly billing (for interstate and intrastate access services combined) is **{BEGIN PROPRIETARY}** **{END PROPRIETARY}** The total amount of security deposits currently held for these access services is **{BEGIN PROPRIETARY}** **{END PROPRIETARY}** or **{BEGIN PROPRIETARY}** **{END PROPRIETARY}** of average monthly billings.

Verizon does not typically send embargo notices to end-user customers. For this category of customers, Verizon has included a list of accounts that have been disconnected and that have current outstanding final balances for interstate or intrastate access services. Verizon's systems do not track the reasons for disconnections; therefore, this list includes services that could have been disconnected for any reason, including disconnections made at the customer's request. *See* Exhibit A-4, attached. For end users in the East, the average current monthly billings are **{BEGIN PROPRIETARY}** **{END PROPRIETARY}** and there are outstanding security deposits in the amount of **{BEGIN PROPRIETARY}** **{END PROPRIETARY}** which is **{BEGIN PROPRIETARY}** **{END PROPRIETARY}** of average monthly billings. For end users in the West, the average monthly current billing is **{BEGIN PROPRIETARY}**

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Issue 5: The changes in security deposit and advance payment provisions of Verizon's interstate access tariff would increase customer-supplied funding as well as reduce Verizon's exposure to default. Verizon should address what modifications should be made to its price cap indices and service band indices to account for changes to the capital and risk parameters of price cap that would result. (Designation Order, ¶ 12)

Response:

The Designation Order suggests that the proposed changes in deposits and advance payment provisions of the tariffs will "increase customer-supplied funding as well as reduce Verizon's exposure to defaults." Designation Order, ¶ 12. However, there is no "funding" that comes from a business entity's holding of security deposits. Verizon must retain these amounts as security against a customer's bill, and either credit them to the customer's outstanding balances or ultimately return them to the customer. Thus, there is no sense in which the security deposits can be considered "funding" to Verizon.

Although the availability of security deposits can be presumed to reduce the potential of revenue losses through default, that is the intention of security deposits. As long ago as the early 1980s, the Commission recognized that security deposits were appropriate "to seek to avoid nonrecoverable costs imposed by bad credit risks," and expressly approved security deposit provisions designed to do just that. *1984 Order*, Appendix D, at discussion of Section 2.4.1(A). The current tariff provisions are simply designed to account for the fact that as these "bad credit risks" grow and change, the tariff terms designed to "avoid" such "bad credit risks" must likewise evolve to keep pace.

Moreover, there are no modifications required to any price cap indices or service band indices as a result of this tariff change as there is no substantive change in the capital and risk parameters of price caps. In fact, there is a necessary adjustment, not from the tariff change, but from the increased exposure to carrier defaults. In 1990, when Verizon went into price caps, carrier defaults made up a small proportion of a relatively stable level of uncollectibles. In recent years, carrier uncollectibles have increased out of all proportion to the customer base as a while. Just since 1996, the percentage of Verizon uncollectibles attributable to carriers has grown from approximately 2% of uncollectibles to more than 10 to 15 times that level (roughly 30%). This increase mirrors the headlines of an industry restructuring with more than 50 telecommunications companies declaring bankruptcy in the past two years. And the problem is continuing to grow. Verizon's receivables that are outstanding more than 90 days grew 150% in a year and a half. As a result of the dramatically higher uncollectible levels today as compared to the initialization of price caps, an upward exogenous adjustment is appropriate. While the new tariff provisions are one way Verizon is attempting to mitigate these problems, such provisions cannot fully alleviate the problems, and other adjustments will be required.

Issue 6: To assist the Commission in understanding the increase in the level of uncollectibles, Verizon should describe its billing and collection procedures and explain any changes in its billing or collection procedures or the accounting treatment of disputed amounts on bills within the past two years that could have affected the levels of uncollectibles. (Designation Order, ¶ 13)

Response:

Although unrelated to billing and collections or accounting, it is worth mentioning that one of the largest factors that has contributed to the growth in outstanding receivables is the recent, growing number of customers that are going out of business and filing for bankruptcy. For example, bankruptcies hinder collections, because once a customer files for bankruptcy, Verizon is limited in the amounts and types of collections efforts it can undertake. In addition, generally accepted accounting principles ("GAAP") require that the estimated risk associated with not collecting receivables be recorded as a receivable reserve and a charge to income. Thus, although there has been no change in the accounting treatment of disputed amounts in the past two years, because the risk associated with uncollectibles has grown dramatically in recent years, the amount of this reserve also has grown. However, the growth in reserve is due to the growth in delinquent receivables, not to any accounting change.

The billing and collection procedures for customers tracked through CABS West are set forth in exhibits A-5 and A-6, attached. These procedures are in place for all carriers, as well as for those end users located in Verizon-West. Although these systems are used for end users in Verizon-West, Verizon will refer to the department that includes carriers and Verizon-West end user customers as the "Wholesale department." Before November 2001, the service center for the Wholesale department was called the Access Carrier Service Center ("ACSC"), which had the primary focus on servicing customer claims. In November 2001, it was split into three groups: bankruptcies, collections, and claims. Because there now is a separate entity devoted to collections, Verizon has been able to increase the focus on attempting to collect from non-paying customers. During the last year, the Wholesale department has also created more standard processes, which also has aided in collections. For example, the language used in letters to customers has become more standard. In addition, the department has created documentation of standard collection processes. In the last year, the Wholesale department also has implemented more formalized tracking of treatment letters sent to customers, which has kept management more informed. However, the department also has instituted a requirement that higher-level approvals (from management and legal) are necessary before treatment letters can be issued, which has tended to slow the issuance of such letters.

End users in Verizon-East territory in some instances operate under a different billing and collections system than the Wholesale department. The collections process for both billing systems in Verizon-East (CABS North and CABS South) are summarized in Exhibit A-7. The billing and collections procedures for these systems have not changed in recent years.

__Issue 7:__ Indicate the average length of time from bill date until bill is sent to carrier customer and what percentage of those bills, by number of entities and by billed amount, is sent electronically. (Designation Order, ¶ 13)

__Response:__

See attached Exhibit A-8 for the percent of bills that are sent electronically. Because Verizon's systems track bills, not customers, the percentages are stated by percent of bills (rather than customers), and percent of billed amounts.

In the East, paper bills are issued within ten days after the bill date for each billing cycle; electronic bills are issued within three days of the bill date. In the West, paper bills are issued within eight days of the bill date; electronic bills are issued within four days of the bill date.

__Issue 8:__ Provide the number of customers that have been sent non-payment, discontinuance of service, or refusal of new orders letter in past year, and average length of time from a bill's being delinquent until the letter was sent. (Designation Order, ¶ 13)

__Response:__

In the past year, **{BEGIN PROPRIETARY}** **{END PROPRIETARY}** carriers have received some type of treatment letter, whether for non-payment, discontinuance of service, or embargo. One type of treatment letter is a payment arrangement treatment letter, which is sent to the customer within thirty to sixty days of a balance becoming overdue. This reviews the terms of the agreement or confirms payment arrangements agreed to by phone. Another is an embargo notice, which informs the customer that Verizon will refuse new orders of service if outstanding balances are not paid. On average, embargo notices are sent after a balance is ninety days or more past due. **{BEGIN PROPRIETARY}**

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End user customers are not sent embargo letters, because they typically are not requesting a high volume of new orders of service. For end users in the West, **{BEGIN PROPRIETARY}** **{END PROPRIETARY}** were sent discontinuance of service notices in the past year. On average, end user customers in the East receive discontinuance of service letters anywhere from 60 to 120 days after the bill is delinquent. In the East, Verizon does not track the number of notices sent to end user customers.

Issue 9: For billing periods from January 2000-present, provide percent of carrier bills disputed, percent of carrier-billed revenues disputed, and percentage of disputed amounts successfully disputed by carrier. Verizon also should indicate whether disputed amounts are deducted from amounts billed for purposes of determining whether a carrier has complied with a deadline. (Designation Order, ¶ 13)

Response:

See attached Exhibit A-9 for percent of carrier bills disputed, percent of carrier-billed revenues disputed, and percentage of disputed amounts successfully disputed by carrier billing periods from January 2000-present. (Bill counts from the year 2000 for the South are not available.)

Verizon does deduct disputed amounts from amounts billed for purposes of determining whether a carrier has complied with a deadline.

<u>Issue 10:</u> Indicate which services in its interstate access tariff, including subscriber line charge and other common line services, are billed in advance and those that are billed in arrears. (Designation Order, ¶ 14)

<u>Response:</u>

Charges associated with service usage (switched access) and the Federal Government are billed in arrears. Charges for all other services generally are billed in advance. However, even for charges that are *billed* in advance, payment typically is not due from the customer until after the services are rendered.

<u>Issue 11:</u> Indicate percentage of interstate billings billed in advance, and how this level has changed over the past 5 years, and how the change in percentage of interstate billings has affected the risk Verizon faces. (Designation Order, ¶ 14)

<u>Response:</u>

Following is the percentage of interstate billings billed in advance for the past three years. The data for the prior two years is not readily available. This data is for both switched and special access services. **{BEGIN PROPRIETARY}**

{END PROPRIETARY}

The increases in the percentage of interstate billings that are billed in advance can be attributed to new rate elements, such as the PICC and trunk ports, to the shift of line port revenues from the traffic sensitive basket to the common line basket, and the transition of marketing expenses from to the common line basket. In addition, the increase in the percentage of revenues billed in advance is partially attributable to the fact that switched access revenues have declined relative to special access revenues during the past three years. Switched access revenues are generally billed in arrears and special access generally in advance.

However, the shift in recovery from accounts billed in arrears to accounts billed advance does not reduce the risk or exposure that Verizon has for past due amounts. As explained in more detail in Exhibit A, Issue 13, *infra*, even if a service is billed in advance, it typically is not due to be paid until thirty days after the bill date – *i.e.*, after the customer has already received the services. Moreover, the Verizon billing systems and collection processes generally allow for 30 or more days of past due amounts, before there is a determination made that there is a default amount. Whether the amounts billed were billed in advance or arrears, the payments are always due after the services have been rendered. Thus, although Verizon typically should be alerted to a payment problem one month earlier for services billed in advance (and thus, potentially can try to prevent a loss of future unpaid services one month earlier), even for services billed in advance it typically will have provided two months or more of unpaid service before it takes any action on the default. Therefore, there is little difference in risk exposure related the manner in which the services are billed.

Issue 12: Verizon has multiple business relationships with many of its access customers. For example, an IXC could also be a CLEC and bill Verizon for reciprocal compensation. For the period from January 2000 to July 2002, Verizon should indicate the total amount as well as the net amount owed it by customers it identified as defaulting on access charge payments. (Designation Order, ¶ 14)

Response:

Verizon does not use a standard definition of "default" in the course of its business, and the term is subject to conflicting interpretations. For example, there are customers with outstanding receivables that are past due, but it is unclear what portion of those outstanding receivables will ultimately be determined uncollectible. However, for customers that Verizon has identified as presenting significant credit risks, as of last week it calculated outstanding receivables owed by customers by Verizon as being **{BEGIN PROPRIETARY}** **{END PROPRIETARY}** and the net amount of receivables, less amounts Verizon owed to those same customers, as **{BEGIN PROPRIETARY}** **{END PROPRIETARY}**

Issue 13: Discuss whether different security deposit provisions should apply, depending on whether service is billed in advance or in arrears. (Designation Order, ¶ 14)

Response:

The deposit provisions should be the same for both services billed in arrears and those billed in advance. This is because that there is a significant difference between *billing* in advance and being *paid* in advance. For example, a customer that is billed in advance may receive a bill on June 4 for services that will occur during the following month (June 5-July 4). However, payment on that bill will not be due until 30 days after the bill date – *i.e.*, on July 4. At that point, the customer has already received the services for which it is being billed. Thus, even when a customer is billed in advance and pays on time, it will be paying the month *after* services have been rendered. Even for services that are billed in advance, if a customer does not timely pay for one month's service and Verizon then gives the customer thirty days before discontinuing service, the customer has received two months of service without payment. Therefore, even for services that are billed in advance, a two-month security deposit is the *minimum* that is required.

Issue 14: Discuss the extent to which Verizon has a debtor relationship with its customer and how that may affect Verizon's credit risk. (Designation Order, 14)

Response:

Even when Verizon is purchasing services from some of its customer-carriers, that generally does not mitigate the level of risk that Verizon faces with uncollectibles. As an initial matter, the amounts that Verizon may owe another carrier (in most cases, this is limited to reciprocal compensation or compensation for ISP-bound traffic) for the most part are not nearly as large as those amounts the carrier-customer owes to Verizon. For example, compared to the more than **{BEGIN PROPRIETARY}** **{END PROPRIETARY}** in debt to Verizon amassed by WorldCom in the months prior to its bankruptcy filing, Verizon's average monthly undisputed intercarrier compensation payables to all the WorldCom entities was a combined average of only **{BEGIN PROPRIETARY}** **{END PROPRIETARY}** per month. *See also* Exhibit A, Issue 12, supra.

Moreover, carrier operations are frequently organized by state jurisdiction, and in many cases CLECs have organized separate carrier entities to pursue specific business plans that many not generate intercarrier compensation. In many cases, there simply will not be a match of debt against intercarrier compensation obligations when these corporate formalities are taken into account. For example, NorthPoint and Rhythms created significant debt exposure for Verizon, and yet presented virtually no payment obligations flowing from Verizon to those carriers, and thus no opportunities for setoff. In addition, even when setoff is available, customers often vehemently oppose Verizon's rights to use amounts it owes the customer as an offset against pending debt the customer owed Verizon.

Issue 15: Indicate the amount of unpaid bills of defaulting customers that have gone into bankruptcy since January 2000, and the percentage of that amount it has recovered through bankruptcy proceedings. (Designation Order, ¶ 15)

Response:

For all bankruptcies since the start of 2000, the combined total pre and post-petition debt is roughly **{BEGIN PROPRIETARY} {END PROPRIETARY}** Of those bankruptcies that have been settled, the combined pre and post-petition debt is **{BEGIN PROPRIETARY} {END PROPRIETARY}** In those bankruptcies, Verizon has received approximately **{BEGIN PROPRIETARY} {END PROPRIETARY}** in cure and settlement payments (between pre and post-petition debt), yielding a **{BEGIN PROPRIETARY} {END PROPRIETARY}** for recovered money on these settled bankruptcies. The vast majority of bankruptcies are still open and it could take years to recover any cure or settlement money.

Issue 16: Discuss whether the proposed tariff is consistent with the US Bankruptcy Code and precedents given that bankruptcy law contains provisions addressing payment to utilities by debtors. (Designation Order, ¶ 15)

Response:

These provisions are fully consistent with the United States Bankruptcy Code. In the first instance, most of the proposed tariff changes address pre-bankruptcy situations for which the code has no relevance. The provisions are designed to protect Verizon from a defaulting customer that may or may not ever declare bankruptcy. To the extent it does declare bankruptcy, there is nothing in the proposals that attempts to override the Code. Indeed, the Code specifically contemplates situations where the bankrupt company will have outstanding letters of credit, pre-payments for services or deposits with vendors.[10] Moreover, the one tariff trigger that specifically mentions bankruptcy is also consistent with the Code. The Code allows a utility to "alter, refuse, or discontinue service" within twenty days after the bankruptcy order of relief if the debtor or its trustee does not furnish "adequate assurance of payment, in the form of a deposit or other security, for service after such date."[11] Although it is true that the bankruptcy court is the final arbiter of what constitutes "adequate assurance of payment," courts have specifically held that "[t]he amount constituting adequate assurance of payment *may be initially set by the utility*."[12] If the debtor objects to the amount of "adequate assurance" required by the utility, then the court may modify the amount. *See* 11 U.S.C. § 366 (b); *In re Tarrant*, 190 B.R. at 708. However, "the utilities have a right to the deposit as demanded unless the debtor can show cause to reduce it." *In re Best Products*, 203 B.R. at 54 (citation omitted). Courts in bankruptcy cases more than once have held that a security deposit equal to two months or more of charges is an appropriate amount to require from the debtor in order to continue service.[13] They have also held that payment in advance or letter of credit may be required as adequate assurance.[14]

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[10] *See, e.g.,* 11 U.S.C. §§ 365, 366.

[11] *See* 11 U.S.C. § 366(b). Although "other security" is not defined, "courts appear to have implicitly construed the term 'other security' to mean prepayment of bills, shortened payment deadlines, a letter of credit, a surety bond, or some similar financial device." *In re Best Products Co.*, 203 B.R. 51, 53-54 (E.D.Va. 1996) (citing cases).

[12] *In re Tarrant*, 190 B.R. 704, 708 (S.D.Ga. 1995) (emphasis added); *see also In re Best Products*, 203 B.R. 51, 54 (E.D.Va. 1996).

[13] *See, e.g. In re Smith, Richardson & Conroy, Inc.*, 50 B.R. 5, 6 (S.D. Fla. 1985) (finding that offer to prepay for services was not adequate assurance, and utility's demand for security deposit approximating the cost of service for *three* months was reasonable); *Lloyd v. Champaign Telephone Co.*, 52 B.R. 653, 656 (S.D. Ohio 1985) (telephone company's request for a security deposit of *2.3 times* the debtor's average

Moreover, the fact that the provisions are consistent with the Bankruptcy Code is further evidenced by the fact that some of Verizon's tariffs *already in effect* allow for the collection of a security deposit from a customer that "has filed for bankruptcy."[15] And these terms also are consistent with provisions in other carriers' tariffs.[16]

<u>Issue 17:</u> If Verizon believes that the risk of uncollectible debts has increased permanently, explain what accounts for this change, e.g., the general economic climate or some structural change in the market. If structural, are there methods that would adequately address this additional risk, *e.g.*, is there a subset of carriers that can be identified that are the major cause of the increased risk? (Designation Order, ¶ 16)

<u>Response:</u>

The uncollectibles have increased to their current level because of the dynamics of the telecommunications industry as a whole, and because of the limited mechanisms that Verizon has in the current tariffs to protect itself from carriers that have questionable credit, poor payment history or that are on the verge of default. They are in large part structural changes due to the move to a competitive telecommunications marketplace. When the market rather than regulators sets the rules, some carriers will succeed and some will fail. The current period probably reflects an accelerated shakeout of unsuccessful competitors, due in part to recent bad investment and business decisions by these companies and a general economic downturn. However, while this period of

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monthly billing was reasonable, as it was the same deposit the company required from other customers with flawed credit histories).

14 *In re Best Products Co.*, 203 B.R. 51, 53-54 (E.D.Va. 1996) (citing cases).

15 *See, e.g.*, BOC Tariff (for Verizon, BellSouth, SBC, and Qwest) FCC No. 1, 800 Service Management System (SMS/800) Functions, § 2.4.1(B) ("SMS/800 Tariff"); Verizon West Coast Inc. General Exchange Tariff, Section 2, Establishment and Re-Establishment of Credit, A.1.b (Cal. P.U.C. Sheet 13, eff. May 1, 1997).

16 *See, e.g.,* AT&T Communications Tariff FCC No. 30, § 3.5.5(A); WorldCom Texas PUC Tariff No. 1, § 2.7; US LEC Tariff FCC No. 2, § 2.5(A)(1); Sprint Schedule No. 11, § 2.11.

financial turmoil likely will eventually slow, it will not stop. As long as the telecommunications landscape remains competitive, some companies will fail, and will leave the market owing money to other carriers. In addition, unless ILECs such as Verizon are given increased latitude to mitigate against the business failures of others, such as by being able to request adequate assurance of payment or promptly to terminate or embargo services to non-paying customers, the uncollectibles problem will become a permanent structural problem for ILECs.

Issue 18: Discuss any other steps, other than requiring additional security deposits, that might be taken to mitigate the risk of uncollectible debts. Comment on the efficacy of the alternative of phasing in a deposit requirement over several months after a trigger had been reached. (Designation Order, ¶ 16)

Response:

The revised tariff provisions were specifically designed to provide several steps, other than requiring a cash security deposit, to mitigate the risk associated with uncollectibles. First, the provisions allow for customers to provide a letter of credit, or pay one month in advance for services, in lieu of a two-month cash security deposit. *See* Verizon FCC Tariff No. 1, §§ 2.4.1(A)(2) and (3). These solutions were designed to give Verizon flexibility in dealing with customers who wish to provide adequate assurance of payment other than a cash security deposit. In addition, shortening from thirty to seven days the notice period before Verizon can terminate or embargo service will help limit the amount of additional services Verizon has to provide to customers that have demonstrated an unwillingness or inability to pay for past services. *Id.* § 2.1.8(A). Shortening the period in which a customer is required to comply with a request for a security deposit (or letter of credit or advance payments) similarly limits future losses. *Id.* § 2.4.1(A)(4).

The alternative of having a deposit phased in over time is completely inadequate as a protection against further bad debt, and may actually exacerbate the problem. Customers that have not paid recent bills and also cannot promptly provide *either* a cash security deposit *or* a letter of credit *or* advance payments likely represent significant financial risks to Verizon that must be addressed immediately. Indeed, if a customer cannot get a letter of credit, requiring Verizon to continue to provide services without adequate assurance of payment is tantamount to requiring Verizon to guarantee debt (in the form of unpaid services) when all banks have refused. Moreover, as has been shown by recent events, there often is a very short time between when a customer's financial difficulties first come to light and when the customer goes out of business or files for bankruptcy. Thus, allowing customers to "phase in" deposit payments will provide little if any protection against nonpayment, and may cause Verizon to continue to provide services over a longer ("phase-in") period, thus increasing the bad debts Verizon ultimately will suffer.

Issue 19: Explain the difference between a "deposit" as stated in Section 2.4.1(A)(1) and "security deposit" as stated in Section 2.4.1(A)(2). How does the proposed Section 2.4.1(A)(1) work with the proposed Section 2.4.1(A)(2) or 2.4.1(A)(3)? May Verizon collect more than 2 months' deposit? (Designation Order, ¶ 18)

Response:

There is no difference between a "deposit" and a "security deposit." Sections 2.4.1(A)(2) and 2.4.1(A)(3) operate independently in that a deposit may be required under the terms of either section. However, even if a customer satisfies more than one criteria for a deposit, Verizon cannot require that the customer maintain more than a two-months' deposit.

Issue 20: Why should advance payments not be based on a rolling average of the previous 3 months' billing? (Designation Order, ¶ 18)

Response:

Verizon has to undertake manual calculations in order to "true up" the advance payments with the previous months' billings. It would be extremely burdensome for Verizon to have to conduct this true up procedure every month, for every account, for every customer from which advanced payments are required.

Issue 21: Verizon "may" or "elects" to collect a deposit in sections 2.4.1(A)(2) and (3). What would prevent Verizon from collecting a security deposit or advance payment from one customer and nothing from another? Explain how these tariff provisions can be applied in a non-discriminatory manner. (Designation Order, ¶ 19)

Response:

As explained more fully in the answer to Exhibit A, Issue 1, above, the tariffs do not grant Verizon unlimited discretion regarding security deposits or advance payments – it can require such payment assurances *only* if a customer has presented objective evidence of lack of creditworthiness. Moreover, there is simply no incentive for Verizon to apply these provisions in a "discriminatory" manner. In fact, there are disincentives to require a deposit or advance payments unless Verizon believes they are absolutely necessary to protect against the risk of customer bad debt. Pursuant to the tariffs, Verizon must pay significant interest of 18.25% to the customer on security deposits. And advance payment calculations must be performed manually, and updated periodically, at considerable cost and burden to Verizon.

These provisions are designed to give flexibility to the customer, rather than requiring Verizon to demand a deposit or advance payments whenever certain triggers are met. They give no more discretion that Verizon already has in existing tariff provisions to terminate or embargo service. Because the existing tariffs properly give Verizon the discretion not to terminate or embargo service to customers in every situation in which it is entitled to do so, it is reasonable to give Verizon similar discretion in imposing lesser alternatives.

<u>Issue 22:</u> What criteria would Verizon use to determine whether to require deposit or advance payments with respect to Section 2.4.1(A)(2)? How would a customer know whether it will be required to make a deposit or pay in advance? How would these tariff provisions be applied in a non-discriminatory manner? (Designation Order, ¶ 20)

<u>Response:</u>

Verizon does not have incentives to request security deposits or advance payments unless it believes that they are absolutely necessary to protect against the risk of customer bad debt. Pursuant to the tariffs, Verizon must pay significant interest of 18.25% to the customer on security deposits. And advance payment calculations must be performed manually, and updated periodically, at considerable cost and burden to Verizon. In deciding which customers to request deposits or advance payments from, Verizon will look at a combination of factors, including the size of the outstanding balance due and average monthly billings for future services, whether the customer has outstanding balances that are past due (and, if so, how much past due those balances are), and an assessment of the probability of future default. Verizon intends to work with the customer to decide on which option (cash deposit, letter of credit, or advance payments) would be mutually acceptable.

As stated above in answers to Exhibit A, Issues 1 and 21, the discretion allowed here is no greater than that already present in existing tariffs. For example, if a customer does not timely pay its bills, Verizon has discretion to either require a security deposit or to terminate or embargo new service. Verizon Tariff FCC No. 1, §§ 2.4.1(A), 2.1.8(A)

<u>Issue 23:</u> Provide information concerning the security deposits required of any long distance affiliates. (Designation Order, ¶ 21)

<u>Response:</u>

The tariff provisions for requiring security deposits apply equally to Verizon affiliates and non-affiliates. At present, there are no security deposits from any long distance affiliates.

<u>Issue 24:</u> Provide data on the payment characteristics of defaulting interstate access customers during the year prior to the time the account was ninety days overdue. Present the data in terms that will enable the Commission to identify patterns that may exist in a customer's payment practices prior to default that may permit alternatives to security deposits to be identified and evaluated. (Designation Order, ¶ 22)

<u>Response:</u>

Exhibit A-10 provides data for a sample of five randomly selected defaulting carriers. *See* Exhibit A-10. However, Verizon is not aware of any "typical" pattern for customers prior to the time an account is ninety days or more overdue.

Moreover, the Commission should not limit the application of a security deposit or other measure of adequate assurance of payment based solely on whether a customer fits some pre-determined "pattern."

While a customer's past payment history is still a good predictor of future payment, it cannot be the only one. If Verizon is compelled to wait until a carrier has stopped paying its bills before instituting protective measures, it may be that much more difficult for the defaulting carrier to provide adequate assurances of payments. If, even after a carrier has shown objective indications of a lack of creditworthiness, Verizon and other carriers are forced to wait until *after* these customers stop paying their bills, *plus* a significant amount of time after that (for example, to allow for notice, and a period of negotiation with the customer), before it could embargo (*i.e.* refuse to accept orders for new service, or pending service requests) or discontinue services, Verizon could be left carrying months of carrier bad debt. Given the dollar volumes that many carriers generate through their CLEC and IXC operations, the exposure can be substantial. That is the situation the Verizon and other ILECs finds themselves in today, and it has cost – and, unless remedied, will continue to cost –Verizon and other ILECs hundreds of millions of dollars in uncollectible bad debt. For example, the combined total pre- and post-petition debt owed to Verizon just for bankruptcy cases since the start of 2000 is roughly **{BEGIN PROPRIETARY}** **{END PROPRIETARY}** *See* Exhibit A, Issue 15. Even if Verizon is able to recover part of those amounts owed to it by bankrupt customers, the vast majority of these bankruptcies are still open and it could take years to recover any cure or settlement money.

In addition, requiring ILECs to wait until a financially troubled customer fails to pay its bills before the ILEC will be able to require a security deposit or payment in advance will not insulate these customers from such demands. Other creditors and suppliers of the customers, which are not faced with the regulatory restrictions that are imposed upon Verizon and other ILECs, would demand additional assurance of payment at the earliest signs of customer financial trouble before they would continue to provide services.[17] Thus, requiring ILECs to wait until nonpayment before implementing such protective measures as those set forth in this tariff would only serve to put ILECs in line

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[17] *See, e.g.,* Tanya Irwin and Andrew McMains, *Kmart to Launch "Real Life" Ads*, Adweek Magazines Newswire (Jan. 28, 2002) (reporting that "it is likely that the retailer will be asked to pay for media upfront"); Kevin Maney and Andrew Backover, *WorldCom Drops Bomb on Telecom*, USA Today (July 23, 2002) (noting that vendors "have begun to demand cash payments up front"); Jeffry Bartash, *WorldCom files for Chapter 11* (July 21, 2002) (noting that "nervous WorldCom suppliers have demanded upfront payment").

behind other creditors, ensuring that the brunt of any bad debt would fall disproportionately on Verizon and the ILEC segment of the telecommunications industry.

<u>Issue 25:</u> Provide data, to the extent available, on the level of uncollectibles of other regulated utilities, or in the broader marketplace. Discuss the means those businesses use to address the risks of default; especially how they manage bad credit risks while continuing to provide goods or services to the customer. (Designation Order, ¶ 23)

<u>Response:</u>

Other businesses use measures similar to those set forth in the proposed tariff revisions to address the problem of customer bad debt. For example, many require security deposits or advance credit from customers with questionable creditworthiness.[18] This includes requiring adequate assurance of payment from customers who have shown recent indications of financial troubles, or bad investment-grade ratings.[19] In addition, unlike Verizon, other businesses often will refuse to do business with customers that present bad credit risks.[20]

Verizon has been unable to obtain data regarding the level of uncollectibles for other regulated utilities, or in the broader industries.

<u>Issue 26:</u> Explain why criteria 3, 4, 5, and 6 are valid predictors of the likelihood of a customer paying its access bill, and why each is a better predictor of whether a customer will pay its bills in the future than the customers past payment history. Verizon should also explain how such varied data can be applied in a manner that will not produce

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[18] *See, e.g.,* Robert P. Simons, *The Eye of the Storm: Strategies to Deal with Distressed Companies*, The Legal Intelligencer, Vol. 226, No. 55 (Mar. 21, 2002); Tanya Irwin and Andrew McMains, *Kmart to Launch "Real Life" Ads*, Adweek Magazines Newswire (Jan. 28, 2002); Kevin Maney and Andrew Backover, *WorldCom Drops Bomb on Telecom*, USA Today (July 23, 2002).

[19] *See, e.g., Dominion Peoples to Implement Two-Year "Credit Scoring" Program*, Platts Retail Energy, Sept. 27, 2002; Lori A. Burkhart, *Risky Customers?*, Pub. Utils. Fortnightly, Mar. 1, 2002.

[20] *See, e.g.,* Shannon Buggs, *Insurers Keep Score With Credit*, Houston Chronicle, Oct. 21, 2002, at Front Page.

arbitrary and/or discriminatory results, especially because in most cases the entity upon which Verizon would impose the security deposit would also be a competitor of Verizon itself, or of its long-distance affiliate. (Designation Order, ¶ 21)

Response:

The question of whether the four criteria identified in this question (regarding a customer's admitted insolvency, bankruptcy or receivership, or low-investment grade rating) are "better predictor[s]" than a customer's past payment history simply misses the point. While a customer's past payment history is still a good predictor of future payment, it cannot be the only one. If Verizon is compelled to wait until a carrier has stopped paying its bills before instituting protective measures, it may be that much more difficult for the defaulting carrier to provide adequate assurances of payments. If, even after a carrier has shown objective indications of a lack of creditworthiness, Verizon and other carriers are forced to wait until *after* these customers stop paying their bills, *plus* a significant amount of time after that (for example, to allow for notice, and a period of negotiation with the customer), before it could embargo (*i.e.* refuse to accept orders for new service, or pending service requests) or discontinue services, Verizon could be left carrying months of carrier bad debt. Given the dollar volumes that many carriers generate through their CLEC and IXC operations, the exposure can be substantial. That is the situation the Verizon and other ILECs finds themselves in today, and it has cost – and, unless remedied, will continue to cost –Verizon and other ILECs millions of dollars in uncollectible bad debt. For example, the combined total pre- and post-petition debt owed to Verizon just for bankruptcy cases since the start of 2000 is roughly **{BEGIN PROPRIETARY}** **{END PROPRIETARY}** *See* Exhibit A, Issue 15. Even if Verizon is able to recover part of those amounts owed to it by bankrupt customers, the vast majority of these bankruptcies are still open and it could take years to recover any cure or settlement money.

In addition, requiring ILECs to wait until a financially troubled customer fails to pay its bills before the ILEC will be able to require a security deposit or payment in advance will not insulate these customers from such demands. Other creditors and suppliers of the customers, which are not faced with the regulatory restrictions that are imposed upon Verizon and other ILECs, would demand additional assurance of payment at the earliest signs of customer financial trouble before they would continue to provide services.[21] Thus, requiring ILECs to wait until nonpayment before implementing such protective measures as those set forth in this tariff would only serve to put ILECs in line behind other creditors, ensuring that the brunt of any bad debt would fall disproportionately on Verizon and the ILEC segment of the telecommunications industry.

As set forth below, the specific criteria identified in the tariff are reasonable predictor's of a customer's ability or willingness to pay future bills.

Customer or its Parent Is in Bankruptcy or Receivership, or Admits its Inability to Pay Debts as They Become Due

The revised tariffs allow Verizon to require a deposit or advance payment of charges if a customer or its parent (1) "informs [Verizon] or publicly states that it is unable to pay its debts as such debts become due"; or (2) "has commenced a voluntary

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[21] *See, e.g.,* Tanya Irwin and Andrew McMains, *Kmart to Launch "Real Life" Ads*, Adweek Magazines Newswire (Jan. 28, 2002) (reporting that "it is likely that the retailer will be asked to pay for media upfront"); Kevin Maney and Andrew Backover, *WorldCom Drops Bomb on Telecom*, USA Today (July 23, 2002) (noting that vendors "have begun to demand cash payments up front"); Jeffry Bartash, *WorldCom files for Chapter 11* (July 21, 2002) (noting that "nervous WorldCom suppliers have demanded upfront payment").

receivership or bankruptcy proceeding (or had a receivership or bankruptcy proceeding initiated against it)." Section 2.4.1(A)(2). The Bureau has questioned why these criteria "are valid predictors of the likelihood of whether a customer will pay its bills in the future." Designation Order, ¶ 21. The answer should be obvious: if a customer or its parent satisfies one of the criteria above, it is stating that it is *unable* to pay all of its future bills. In that instance, the fact that the customer paid its bills in the past is of little comfort to a supplier, such as Verizon, that will continue to provide services in the future. Indeed, the fact that a customer that has filed for bankruptcy is more likely to default on future payments is further evidenced by the fact that the Bankruptcy Code specifically allows utilities to require "adequate assurance" of payment before continuing to provide service to the bankrupt debtor.[22] Although Verizon can seek a deposit or advance payment provisions pursuant to the Bankruptcy Code, it is important to allow Verizon to demand such protections in its tariffs, as courts have specifically held that "[t]he amount constituting adequate assurance of payment *may be initially set by the utility*."[23]

Moreover, Verizon's tariffs already in effect use bankruptcy as a trigger for requiring a security deposit.[24] Other carrier's tariffs have similar provisions. *See, e.g.*,

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22 *See, e.g.*, 11 U.S.C. § 366(b) (A "utility may alter, refuse, or discontinue service if neither the trustee nor the debtor, within 20 days after the date of the order for relief, furnishes adequate assurance of payment, in the form of a deposit or other security, for service after such date.").

23 *In re Tarrant*, 190 B.R. 704, 708 (S.D.Ga. 1995) (emphasis added); *see also In re Best Products*, 203 B.R. 51, 54 (E.D.Va. 1996). As stated in Exhibit A, Issue 16, the proposed tariff provisions are entirely consistent with United States bankruptcy law.

24 *See, e.g.*, BOC Tariff (for Verizon, BellSouth, SBC, and Qwest) FCC No. 1, 800 Service Management System (SMS/800) Functions, § 2.4.1(B) ("SMS/800 Tariff"); Verizon West Coast Inc. General Exchange Tariff, Section 2, Establishment and Re-Establishment of Credit, A.1.b (Cal. P.U.C. Sheet 13, eff. May 1, 1997).

AT&T Tariff FCC No. 30, § 3.5.5(A). Indeed, even though several commenters vehemently opposed Verizon's proposed tariffs, including the provisions that set potential bankruptcy as a trigger, *not one* questioned whether these criteria were reasonable predictors of a customer's inability or unwillingness to pay future bills.

Investment Grade Rating

The other two criteria questioned in the Designation Order state that Verizon may require a deposit or payment in advance if the senior debt securities of a customer or its parent are below investment grade, or are rated at the lowest investment grade rating category by a nationally recognized statistical rating organization and are put on review for a possible downgrade. Verizon Tariff FCC No. 1, § 2.4.1(A)(2). These criteria are specifically defined by reference to objective definitions found in federal securities regulations, and thus cannot be characterized as "ambiguous" or "vague." *See id.*, § 2.4.1(A)(2).[25] They establish concrete, objective criteria for invoking the right to request additional assurances of payment – criteria that are far less vague than the language many of the carriers opposing these tariffs have long included in their own tariffs.[26]

Moreover, these criteria are reasonable predictors of whether a customer will pay its bills in the future. It is well established that "[c]redit ratings provide objective, consistent and simple measures of creditworthiness" and are regarded as "a key measure

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[25] For example, while one commenter argued that the term "nationally recognized statistical rating organization" is vague, it is a term that is used repeatedly in SEC regulations that reference "investment grade" ratings. *See, e.g.*, 17 CFR § 240.3a1-1(b)(3)(v).

[26] *See, e.g.*, WorldCom Tariff No. 1, § 2.7 (stating that it can require a deposit of a customer "whose credit worthiness is not acceptable to the Company or is not a matter of general knowledge"). *See generally* Verizon Tariff Reply, Exhibit C, at 1.

of a company's financial health."[27] Private contracts often use downgrades in investment ratings as triggers for requiring adequate assurance.[28] Indeed, Moody's reports that "over 90% of all rated companies that have defaulted since 1983 were rated Ba3 [one of the highest "junk" grade ratings] or lower at the beginning of the year in which they defaulted."[29] As a corollary, one commenter opposing Verizon's tariff revisions noted that public data shows that *one in ten* issuers of securities that currently are below investment grade will default on the securities. *See* WorldCom Tariff Opposition, at 10-11.

And it appears that currently for the telecommunications industry, the default rate is much higher than average. According to one analyst, "Through the first half of 2002, 55% of defaults by volume and 37% as a percentage of issuers have been telecommunications firms."[30] In addition, because defaulting on securities obligations will often trigger default clauses and shut off future financing, these companies are likely

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27 Moody's Investor Service, Rating Policy, "Understanding Moody's Corporate Bond Ratings and Rating Process," at 5 (May 2002) *available at* www.moodys.com/moodys/cust/ratingdefinitions/rdef.asp; BusinessWeek Online, "The Credit-Raters: How They Work and How They Might Work Better," (April 8, 2002), *available at* www.businessweek.com/magazine/content/02_14/b3777054.htm.

28 *See* Moody's Investor Service, Rating Policy, "Understanding Moody's Corporate Bond Ratings and Rating Process," at 6 (May 2002) ("Investors and counterparties embed ratings as triggers into private contracts in order to protect themselves from potential deterioration in the creditworthiness of an obligor's financial position"). *See also* Jonathan Stempel, Issuer in the News, "Moody's, S&P Say Demanding More Disclosure on Risks," Feb. 6, 2002, *available at* www.markets.reuters.com/cabonds/Editorial/IssuerInTheNews/IssuerInTheNews898.htm (noting that companies' contracts often have clauses requiring that they pay off their debt or pay a higher interest rates in the event of an investment downgrade).

29 Moody's Investor Service, Rating Policy, "Understanding Moody's Corporate Bond Ratings and Rating Process," at 9 (May 2002).

30 *See* Moody's Investor Service, Special Comment, "Corporate Defaults Refuse to yield in 2002", at 4 (July 2002) *available at* riskcalc.moodysrms.com/us/research/defrate/Q202_comment.pdf.

to default on securities obligations last – *i.e.*, long *after* they have stopped paying their bills for telephone service. Verizon's own internal analysis confirms this. Verizon looked at selected carrier customers with outstanding balances above a threshold (more than $1.75 million dollars) as of a date certain in July.[31] Of the companies with publicly rated securities, there was a correlation between below investment grade S&P credit ratings and the percent of billable revenues outstanding 90 days or more for these customers. *See* Verizon Tariff Reply, at 14 & Exhibit D. A copy of the exhibit illustrating that point is attached at Exhibit A-11. In other words, the lower the customer's credit rating, the more likely it is the customer will have a higher percentage of its outstanding receivables due for 90 days or more.

Issue 27: Verizon should discuss its intentions, if any, with respect to residential end users. (Designation order, ¶ 21)

Response:

Verizon does not have any plans to revise its residential end-user tariffs to amend the conditions regarding the criteria for requesting a security deposit and/or advance payment. As stated in more detail in Section I of the Direct Case brief, the carrier portion of uncollectibles has been rising far more dramatically than the end user portion. Moreover, because the amounts of money charged for services to each individual residential end user customer are much smaller than those at issue with access customers, the risks of individual residential end user default are much smaller. Therefore, at this time Verizon has concluded that residential end user tariffs do not warrant the same measures for ensuring adequate assurance of payment.

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[31] Data from customers in the Northeast and Western states were used for this analysis. Because of differences in accounting for the number of days receivables are outstanding, data from Mid-Atlantic states were not used.