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140 West Street
27th Floor
New York, NY 10007-2109
Tel (212) 321-8126
Fax (212) 962-1687
joseph.a.post@verizon.com

Joseph A. Post
Assistant General Counsel – NY

verizon

May 21, 2007

BY HAND

Honorable Jaclyn A. Brilling
Secretary
New York Public Service Commission
Three Empire State Plaza
Albany, New York 12223 - 1350

Re: Case 06-C-0897

Dear Secretary Brilling:

Verizon New York Inc. ("Verizon") is today filing tariff amendments that would add a new § 1(A)(16) to the General Regulations section of Verizon's Tariff PSC No. 1. The new section would implement a limited form of supplemental pricing flexibility for most retail business services. This letter transmits two analyses (Attachment 1 and Attachment 2) that set forth the rationale for seeking this expansion of the pricing flexibility currently available for retail business services under Verizon's tariffs. Attachment 1 provides a legal and policy analysis of Verizon's proposal, and Attachment 2 provides factual background on the state of competition in the market for retail business services in New York.

Certain information included in Attachment 2 has been designated by Verizon as Protected Information under the Protective Order issued in this case. Because the Protective Order applies only to information provided to the parties (as opposed to information provided to the Commission or the Department of Public Service), we are also submitting a letter to the Commission's Records Access Officer requesting that the relevant portions of Attachment 2 be classified as trade secret information and confidential commercial information under the Public Officers Law and the Commission's Rules of

Procedure. Staff can obtain unredacted copies of the filing through the Records Access Officer in accordance with the Commission's rules.

Respectfully submitted,

Joseph A. Post

cc: Service List for Case 06-C-0897 (By Overnight Delivery)

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

Tariff Filing of Verizon New York Inc. to Implement Pricing Flexibility for Non-Basic Services	Case 06-C-0897

VERIZON NEW YORK INC. TARIFF FILING TO IMPLEMENT LIMITED PRICING FLEXIBILITY FOR RETAIL BUSINESS SERVICES

ATTACHMENT 1: DESCRIPTION AND JUSTIFICATION

JOSEPH A. POST
140 West Street — 27th Floor
New York, NY 10007-2109
(212) 321-8126

Counsel for Verizon New York Inc.

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VERIZON NEW YORK INC. TARIFF FILING TO IMPLEMENT LIMITED PRICING FLEXIBILITY FOR RETAIL BUSINESS SERVICES

ATTACHMENT 1: DESCRIPTION AND JUSTIFICATION

I. INTRODUCTION AND BACKGROUND

In 2006, Verizon New York Inc. ("Verizon") filed tariff amendments to implement "Full-Flex" pricing flexibility for retail business services. "Full-Flex" was the name Verizon used for the form of pricing flexibility that the Commission had authorized for virtually all non-basic retail residential services in the Commission's *Competition III Order*.[1] It authorizes Verizon to increase or decrease its prices to any level, without substantive review, on one day's notice. The Commission required that Full-Flex price changes for residence services be made on a statewide basis; in other words, such changes would apply to all Verizon customers in New York who purchased the service in question (the "uniformity rule"). Verizon did not propose to incorporate the uniformity rule into its 2006 Full-Flex filing for business.

Verizon's filing drew strong opposition, and in December 2006 the company decided to withdraw it voluntarily, with a view towards modifying it to meet some of the objections and re-submitting it at a later time. Thus, the filing was never ruled on by the Commission.

Verizon continues to believe that full pricing flexibility — equal to or beyond that authorized by the Commission for Verizon's non-basic retail residential services — is warranted for retail business

[1] Case 05-C-0616, "Statement of Policy on Further Steps Toward Competition in the Intermodal Telecommunications Market and Order Allowing Rate Filings" (issued and effective April 11, 2006). Full-Flex pricing for residence services is implemented in Verizon Tariff PSC No. 1, § 1(A)(9).

services as well. Nevertheless, as a preliminary step, and in order to obviate certain of the objections that were asserted to our original filing, the company is filing proposed tariff revisions providing for a more limited form of pricing flexibility. Since 2006, pricing flexibility for retail business services has become an even more critical priority for Verizon, in view of the continued erosion of its access lines and financial indicators in New York. Verizon is submitting this modified proposal at this time because it is urgent for the company to take at least preliminary steps towards the greater regulatory flexibility enjoyed by its competitors in the market for retail business services. Pricing flexibility for retail business services is amply warranted by the vigorous, pervasive, and permanently entrenched competition for such services that exists today in this state.

The limited pricing flexibility described in this filing would apply to all retail business services, with the exception of Public Access Lines, which are subject to specific regulatory requirements and to rates set by the Commission in a June 20, 2006 order.[2] Price changes for other retail business services could be made on one-day's notice, following the same procedures as are utilized for Full-Flex price changes for residence services. There would be no substantive restrictions on downward pricing flexibility: prices of eligible services could be decreased to any level. However, upward pricing flexibility would be limited to 25% per year for any individual rate element. A higher annual percent increase would be permitted for rate elements that are comparatively low and that therefore would not contribute significantly to the total rate paid by a customer purchasing an eligible service. Price increases for 1MB service (message rate business access lines) would be limited to 10% per year.

Notably, Verizon proposes to apply the uniformity rule to price changes made under the proposed tariff, thus departing from the position that the company took in its 2006 Full-Flex filing for business services.

Cases 03-C-0428 and 03-C-0519, "Order Resolving Complaints and Inviting Comments Regarding Public Access Line Rates" (issued and effective June 30, 2006).

The flexibility authorized by the proposed amendments is intended to supplement, not replace, other available mechanisms for changing prices. The Commission has already allowed pricing flexibility, according to a wide variety of different rules, for many specific retail business services;[3] those established flexibility rules will continue to be available as alternatives to the new form of pricing flexibility allowed by this filing. Price changes made through such other available mechanisms will not be subject to the time periods, restrictions, or other regulations governing the new form of flexibility added by this filing. (However, Verizon would not be permitted to change prices under the new tariff provisions proposed here where price changes are made to the same rate element during the same calendar under other available price-change mechanisms, and where those other changes, in combination with the changes made under the new flexibility provisions, would result in a rate change beyond the level allowed by the new tariff.)

For several reasons — including its limitations on upward pricing flexibility and its incorporation of the uniformity rule, as well as the change in Verizon's circumstances referred to above — this filing provides an even more compelling case for Commission approval than Verizon's 2006 filing. Indeed, the limited degree of upward flexibility that would be put in place by this filing conforms to what the Commission has considered reasonable for over a decade, since well before the implementation of the

[3] *See, e.g.*, the tariff provisions for the following business services (references are to sections of Verizon Tariff PSC No. 1): 1MB (§ 1.R); certain Custom Calling Services (§ 2.H); Data Over Voice (§ 2.J); Unicall (§ 2.L); Business Intellidial (§ 2.P); Distinctive Ring (§ 2.T); Phonesmart (§ 2.X); Voice Messaging for Small Business (§ 2.EE); Ultraforward (§ 2.HH); Custom Redirect (§ 2.QQ); Advantage Pack (§ 2.UU); certain Supplemental PBX (§ 4.E); certain Centrex (§ 4.I); certain Foreign Exchange Line Mileage (§ 7.C); certain Mileage Between Locations (§ 7.D); Superpath 1.5 (§ 12.G); Superpath Optical 45 Mbps (§ 12.I); Alternative Service Wire Center (§ 12.L); Flexgrow (§ 12.O); certain Enhanced 911 (§ 19.B); certain Private Switched ALI (§ 19.C); Infopath Synchronous (§ 21.A); Infopath Asynchronous (§ 21.B); Switchway (§ 21.C); NYNEX Enterprise Network Reconfiguration (§ 21.F); DDS II (§ 21.H); ISDN Primary (§ 21.J); ISDN Primary Disaster Recovery (§ 21.J.1); NYNEX Enterprise Service (§ 21.K); Enterprise Switched Wideband (§ 21.L); NYNEX Internet Protocol Routing Service (§ 21.P); Enhanced Dedicated SONET (§ 12.Q — ICB-priced); SONET Point-to-Point (§ 12.R — ICB-priced). Flexibly priced business services from other tariffs include certain Frame Relay (Tariff No. 5, § 5.4.1); certain Transparent LAN (*id.*, § 5.4.2); DDS – MetroLATA (Tariff No. 6, § 10.6.1); Econopath Calling Plan (Tariff No. 2, § K.2); Virtual WATS (*id.*, § L.5); NYNEX Business Link Plan (*id.*, § N.3); and Surrogate business Link Plan (*id.*, § O.3).

1996 Telecommunications Act and the recent explosion of traditional and intermodal competition for communications services.[4] Thus, in its 1996 *Framework Order*,[5] the Commission observed that:

> [t]he freedom to change rates rapidly to best reflect demand and costs is consistent with a competitive market. As the transition to competition continues, pricing flexibility must be accorded companies in competitive circumstances. Pricing flexibility, defined as the ability to change rates rapidly with the minimum of regulatory review, should be commensurate with the degree of competition.[6]

The Commission went on to find that "our existing pricing flexibility policies" — which included a ceiling of 25% on price increases per year, one-day price changes, and individual case basis ("ICB") pricing — "are appropriate for dominant providers for competitive services during the transition period," and determined that those policies would be maintained.[7]

> Competitive services provided by dominant companies may continue to be priced flexibly, and the non-discriminatory offering of individual contract pricing to better reflect specific customers' needs and conditions, will be allowed to continue for competitive services.[8]

A fortiori, upward pricing flexibility limited to a 25% ceiling is appropriate in the far more aggressive and pervasive, and better-established competitive environment that prevails today.

* * *

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[4] The pricing flexibility rules implemented by the Commission in the mid-1990s and earlier were explicitly tailored to a "transitional" period preceding the onset of full competition. Clearly, that transition is now complete, thus warranting even greater flexibility.

[5] Case 94-C-0095, "Opinion and Order Adopting Regulatory Framework" (issued and effective May 22, 1996)

[6] *Id.* at 29.

[7] *Id.* (footnote omitted); *see also id.* n.2. Indeed, as already mentioned, Verizon's tariffs for numerous business services currently include pricing flexibility provisions. Some specify min/max flexible pricing ranges that can allow for price increases of more than 25%.

Although the *Framework Order* concluded that somewhat more scrutiny would be warranted for the rates of "bottleneck" services, that restriction is unnecessary here since this filing is limited to retail services and thus excludes wholesale "inputs." Further, the emergence of intermodal alternatives has rendered the "bottleneck" concept obsolete in the local exchange market.

Verizon is submitting two analyses in support of its proposed tariff changes. Attachment 1 — this document — summarizes the legal and policy framework that should be applied to evaluating Verizon's proposal.[9] Specifically, Section II addresses the general standards the Commission has applied in determining whether sufficient competition exists to warrant pricing flexibility; Section III discusses the rationale for the *downward* pricing flexibility sought here; and Section IV discusses the rationale for *upward* pricing flexibility.

Attachment 2 to this filing marshals the evidence demonstrating the existence, strength, and permanence of competition in the market for retail business services in New York. In general, that Attachment takes as its starting point the record that was created in connection with Verizon's 2006 filing, including particularly two reports prepared by National Economic Research Associates, Inc. ("NERA").[10] Attachment 2 does not repeat the detailed data and conclusions presented in the NERA reports, but rather, builds on them by offering supplemental evidence to show that competition is an even more significant force in the retail business-services market in this state now than it was in 2006

The report also includes an "elasticity analysis" demonstrating that in the current competitive environment, significant increases in the price for business services would decrease Verizon's revenues in the long run due to demand-restriction effects. Staff and the Commission have found such analyses to be highly relevant in assessing proposed regulatory changes associated with the emergence of competition.

As the discussions below and in Attachment 2 demonstrate, pricing flexibility for retail business services is consistent with Commission precedent and warranted by the competitive environment in this state. Additionally, it will help mitigate the regulatory asymmetries that continue to hamper free and open competition between Verizon and its lightly-regulated and unregulated competitors.

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[9] Portions of Attachment 1 repeat discussion and analysis that was presented to the Commission in connection with Verizon's 2006 Full-Flex filing.

[10] NERA, "Report on Competition for Retail Business Services in New York State" (August 31, 2006); NERA, "Supplemental Report: Competition for Retail Business Services in New York State" (October 2, 2006). Those reports are part of the record of this proceeding, and the Commission may take administrative notice of them.

II. THE GENERAL FRAMEWORK FOR EVALUATING COMPETITION

The Commission concluded in its *Competition III Order* that full pricing flexibility was appropriate for non-basic retail residential services, and subsequently found that Verizon's "Full-Flex" tariff implemented that flexibility in a reasonable manner.[11] The analytical framework utilized by the Commission to reach those conclusions was developed after extensive consideration of detailed comments, analyses, and data submitted by parties representing a wide range of interests. Although that framework is thus entitled to a great deal of deference in analyzing the issues presented by this filing, it must be kept in mind that the framework established the requirements for obtaining *Full-Flex* pricing flexibility, not the more limited form of flexibility at issue here. Thus, the Commission's *Competition III* analysis provides an upper limit on the showing that should be required to support Verizon's current filing.

In assessing the state of competition in New York in the *Competition III Order*, the Commission emphatically rejected a static, backward looking approach based on current market shares, and instead adopted a forward-looking, dynamic framework based on contestable markets theory. As the Commission explained (quoting a 2006 Staff white paper), that theory "indicates that dominant providers will refrain from monopoly pricing and cost cutting on service equality if competitors can quickly enter and take away a significant share of the incumbent's customers in response to such supra normal profit seeking behaviors."[12] Thus, the Commission rejected market-share-based arguments of the Consumer Protection Board, finding that such arguments "misse[d] the point":

[11] Cases 06-C-0897 and 06-C-0954, Memorandum to the Commission from the Office of Telecommunications (August 15, 2006), approved as recommended and so-ordered by the Commission (effective August 23, 2006) ("*Tariff Approval Order*").

[12] *Competition III Order* at 40 n.93 (quoting Staff's 2006 White Paper at 40).

> CPB's emphasis on historical data does not capture the prospective environment upon which competitors' business plans must be made. Establishing our policy for the future based on that history is unwise.[13]

In lieu of an approach based on market shares, the Commission relied on the availability of multiple competing platforms — including cable telephony, wireless, and application-based services delivered over broadband platforms, in addition to other traditional wireline telephone providers — that served as enablers for competitive service offerings. The Commission concluded that "in view of the dynamic nature of the telecommunications market, Staff's competitive indicator and observations of market trends provide a more meaningful picture of the state of the intermodal competitive market than does the simple look at recent actual market shares that is embodied in the [Herfindahl-Hirschman Index ('HHI')]"[14]:

> While we are aware of the high HHI for wireline mass market voice calling in New York that one can derive from recent actual market shares, the evidence is clear that other factors, including entry by new competitors, play a more crucial role than starting-point HHIs in any analysis of this market. In fact, Staff's competitive indicator focuses on exactly this — the extent of the presence in New York of the newer modes of entry.
>
> Deviation from reliance on HHIs is appropriate here. The broadly defined telecommunications market is expanding at an unparalleled rate, and change is constant. The adoption of internet protocol and the advancement of computer technology cause new entrants to experience lower costs. This allows intermodal competitors rapid and inexpensive entry into the voice market and permits them to contest quickly any monopoly-based pricing of these services by the incumbent. The market is continually expanding, both in scale and scope, causing an ever changing measurement of the size (or total demand) in the market. Static measures of market share such as HHI's do not reflect this reality. Accordingly, measurements of competitor's historic market shares as considered in HHI calculations are of limited significance and provide limited guidance in determining the ability of the intermodal competitive market to constrain monopoly behavior. This market, suitably monitored, can be considered adequately competitive to support the actions we are taking.[15]

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[13] *Id.* at 38 (footnote omitted)

[14] *Id.*

[15] *Id.* at 38-39.

Numerous parties to the *Competition III* proceeding argued that the services provided over alternative platforms such as wireless and broadband were not exact equivalents of the services provided by Verizon, and accordingly should not be taken into account in any competitive analysis. However, the Commission rejected the claim that "the lack of complete substitutability of intermodal services for wireline services renders the White Paper's estimate of the extent of competition unreliable." The Commission also recognized that "[t]elecommunication services are purchased both as a substitute for and a complement to other telecommunications services," and agreed with Staff's conclusion "that bundled telecommunication services, VoIP, and wireless are all in competition with unbundled wireline services, as the incumbent's continuing loss of lines and access minutes strongly suggests."[16]

The Commission also relied on other data that corroborated the competitive nature of the retail markets in New York. These data supplemented the conclusions that could be drawn from the bare presence and ubiquity of competitive enablers. For example, the Commission noted that "[m]any consumers are taking advantage of these [competitive] options and are reaping the benefits of technology and competition; as a result, former monopoly providers are losing customers, lines, usage, and revenues."[17] The Commission noted that these access line losses, and the associated revenue losses, were in turn reflected in Verizon's rate of return and return on equity — which had declined rapidly between 2000 and 2004, and which were both negative in 2003 and 2004 — and in actions taken by securities rating agencies.[18] Further corroboration was provided by Number Resource Utilization Forecast reports,

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[16] *Id.* at 40. *See also* discussion in *id.* at 33 n.72, 34 ("In our judgment, consumers view these offerings as close substitutes to wireline local service."); 34-35 (substitutability of VoIP services); 35 ("a growing number of customers are willing and able to consider wireless as a close substitute for wireline service").

[17] *Id.* at 35 (footnote omitted). On losses of access lines and revenues, *see also id.* at 54-55.

[18] *Id.* at 54-55. The Commission specifically rejected the contention that Verizon's wireline competitive losses "should only be considered in the context of profits made in other competitive lines of business and regulated profits made in other states by [Verizon's] parent company. This would be a significant departure from the traditional approach of reviewing jurisdictional costs and associated revenues. . . . Investors do not typically continue to support one project simply because another unrelated project is profitable. We decline to rely on non-jurisdictional earnings to offset jurisdictional losses." (*Id.* at 55 n.112.)

which showed both rapid increases in numbers assigned to competitive carriers and wireless providers, and decreases in assignments to incumbents,[19] and by the fact that "technological advances and the development of new products and features suggest that intermodal competition with landline service will only increase at an accelerating pace in the next few years."[20]

Based on this analytical framework, the Commission concluded that its "experience and the record in this proceeding reveal . . . that competition in New York's retail telecommunications markets has evolved dramatically over just the past few years, especially in the residential portion of the mass market."[21] "Verizon and Frontier of Rochester in particular are experiencing real losses in market share and revenues as a result of this dynamic market competition. Given the substantial network investments of facilities-based competitors, we expect that they will tenaciously expand and defend their market shares. It is therefore clear that the various forms of intermodal competition are undermining the incumbents' ability to set rates in excess of relevant costs."[22] "The data we now have fully support our conclusion that Verizon's and Frontier of Rochester's prices are being constrained by actual and potential intermodal competitors."[23]

Notably, the Commission concluded that the relevant question was not whether "perfect competition" existed. "Given the inefficiencies inherent in economic regulation, a market need not be perfect, or even near-perfect, to produce better outcomes for consumers than traditional regulation, given the well-documented inefficiencies of the latter, and its shortcomings in an increasingly competitive

[19] *Id.* at 32 n.70.

[20] *Id.* at 36.

[21] *Id.* at 32.

[22] *Id.* at 36 (footnoted omitted).

[23] *Id.* at 40 (footnote omitted).

market."[24] The Commission considered the market for retail residential services to be "an adequately competitive market," and it thus found that the pricing flexibility it authorized was "the best approach for setting just and reasonable rates in this environment."[25]

As is demonstrated by the accompanying report (Attachment 2), and by the previously submitted NERA reports, the precise framework relied on by the Commission in the *Competition III* order to support pricing flexibility for non-basic retail residential services supports — with at least equal and indeed greater force — Verizon's proposal to flexibly price retail *business* services

- As those reports show, facilities that can be used for the provision of competitive business services to all classes of business customers — *i.e.*, the precise type of "competitive indicators" whose presence and ubiquity was analyzed by Staff and relied on by the Commission in the *Competition III* proceeding —are present throughout New York State. These include not only the general wireless and broadband facilities that were the focus of the analysis in *Competition III*, but also telephony-ready cable networks, wireline CLEC switches, and Verizon wholesale services such as resale, Wholesale Advantage, and unbundled loops and transport.[26] Competitors are offering and providing services utilizing these facilities throughout the state to a wide range of business customers, including small-, medium-, and large-sized businesses.

- The competitors offering these alternative services include firms with significant strategic strength, which clearly have the willingness and ability to compete head-to-head with Verizon.

- Verizon has lost substantial numbers of retail business access lines, and those losses, and the associated losses of retail business revenues, are occurring throughout the State. Those losses are associated with rapid growth in the demand for services provided by alternative wireline and intermodal providers, and are clearly caused by competition rather than by declining overall demand for telecommunications services. Moreover, the losses are statewide, and are not confined to the Metro LATA or to urban areas in general.

- The majority of this competition is facilities-based, including competition from cable companies using their own networks, from wireline CLECs using their own switches and in some cases their own access facilities, and from VoIP providers utilizing a variety of

[24] *Id.* at 42.

[25] *Id.*

[26] Other emerging competitive alternatives such as WiMax promise even stronger, more-widespread facilities-based competition in the immediate future.

broadband networks deployed by Verizon and other carriers. Competitors can also use Verizon's wholesale services to "fill in" any gaps in their facilities-based offerings.

- Although financial data such as return on equity are not readily available on a line-of-business basis, it is clear that Verizon's loss of retail business lines and revenues has contributed significantly to the financial trends that the Commission summarized in the *Competition III Order*, and that have continued since that order was issued. Key data concerning Verizon's current finances are set forth in Verizon's just-filed Annual Report to the Commission for 2006. That report shows that Verizon's net income for the year was *negative* \$818.8 *million* dollars[27]; that the company's rate of return was *negative* 4.89%;[28] and that the company's return on common equity was *negative* 73.6%.[29]

- Finally, pricing relief such as that proposed here will enable the Commission to take at least a small step in the direction of eliminating the anticompetitive effect of the substantial regulatory asymmetries that currently exist between Verizon and its competitors: both traditional wireline competitors and cable companies and others relying on VoIP technologies.

For all of these reasons, the current competitive environment generally warrants increased pricing flexibility for business services. In the following two sections, we discuss factors that are specifically relevant to and support the downward and upward pricing flexibility Verizon is seeking.

III. RATIONALE FOR DOWNWARD PRICING FLEXIBILITY

In the *Competition III Order*, the Commission stated that it saw "no need to impute a specific price floor which would only serve to limit the incumbent's ability to compete and to limit the economic benefits consumers could enjoy."[30] Consistent with that statement, Verizon's residential pricing flexibility tariff provides that "[a]ny rate element associated with an Eligible Service may be increased or *decreased to any level*." (Emphasis supplied.) In the *Tariff Approval Order*, the Commission concluded

[27] Annual Report of Verizon New York Inc. for the Year Ended December 31, 2006 to the Public Service Commission ("*2006 Report*"), Schedule 12. Under standard accounting (*i.e.*, without regulatory adjustments), Verizon's consolidated net income for 2006 was approximately *negative* \$ 816 million. (*See* the Verizon consolidated financial data presented in the company's report to its bondholders, available at http://investor.verizon.com/income/subsidiaries/ny/pdf/4Q06_ny.pdf. *See also* the comparison of data reported to the Commission and to bondholders in *2006 Report*, Schedule 2b.)

[28] *2006 Report*, Schedule 10.

[29] *Id. See generally* the discussion of trends in Verizon's net income, return, and ROE in the company's April 23, 2007 comments in Case 07-C-0347.

[30] *Competition III Order* at 67

that "[t]he framework proposed by the company to exercise the rate flexibility granted by the Commission is reasonable, as it is in accord with the Commission's Competition III Order."[31]

In arguing in favor of mandatory price floors in its comments on Verizon's 2006 Full-Flex proposal, One Communications pointed to a separate discussion in the *Competition III Order* in which the Commission stated that "*to the extent there are remaining wholesale bottleneck facilities*, an imputation rule is the theoretically appropriate means to ensure fair pricing."[32] The highlighted qualification is an important one. Imputation rules seek to prevent price squeezes based on above-cost pricing of bottleneck wholesale inputs by vertically integrated firms. To the extent that there are no bottleneck inputs, such rules are not needed. Thus, in footnote 214 of its order, the Commission noted that Staff's White Paper had concluded "that the imputation rule will no longer be needed once all wholesale bottlenecks are eliminated through competition." The data and analyses presented in the NERA reports, supplemented by the additional material presented in Attachment 2, demonstrate the existence of robust *facilities-based* competition by intermodal and wireline providers in New York, and thus belie the notion that there are any significant inputs that can still be characterized as bottlenecks and whose prices are subject to Verizon's control.[33]

Aside from the fact that the Commission has already specifically rejected the need for price floors in highly competitive retail markets, there are other sound policy reasons for not subjecting pricing flexibility to imputation-based price floors. Such pricing restrictions are anti-consumer, anti-competitive, and unnecessary.

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[31] *Tariff Approval Order* at 5

[32] *Competition III Order* at 120 (emphasis supplied)

[33] The discussion of imputation issues in the *Competition III Order* that was cited by One Communications merely establishes the theoretical possibility that the Commission might, in response to an appropriate complaint, require changes in prices for particular retail services or wholesale bottleneck inputs, if any such inputs are found to exist and if their prices are found to violate an appropriate imputation standard.

First, creating barriers to price reductions — which is precisely what an imputation rule would do — would be a perversely anti-consumer regulatory response to a competitive market. As the Commission concluded in a recent order, "the theory of predation should be used with care because it can deprive consumers of rate decreases resulting from the operation of competitive forces." "We would expect to see price reductions for services priced above incremental cost where incumbents like Verizon with declining costs of providing service compete with new entrants that have low entry barriers and declining costs."[34] And in the *Competition III Order* itself, the Commission noted that imputing a price floor "would only serve to limit the incumbent's ability to compete and to limit the economic benefits that consumers could enjoy."[35] These observations are particularly compelling in view of the fact that "the cost of entry for intermodal competitors is less than the wireline LECs['] embedded costs and is falling."[36] Setting costs at an imputed price floor on the grounds that *some* competitors may use Verizon's wholesale inputs creates a highly profitable pricing umbrella for, and eliminates any incentive for price reductions by, intermodal competitors who can avoid the cost of such inputs and take advantage of their own, lower cost structures.

Second, price-floor rules create a regulatory asymmetry that impairs competition. As the Commission's experience has demonstrated time after time over the last several years, cost proceedings are likely to be lengthy and contentious. Even if an imputation formula or algorithm is developed in advance, the development process will by itself delay the necessary move towards competitive parity, and its application in individual cases is likely to involve complex and contentious issues that may require months to resolve — as the Commission discovered in its venture into toll/access imputation. Imputation proceedings will thus make it easy for competitors to find pretexts for delay. Thus, imputation-based advance screening of proposed "flexible" prices would inevitably become yet another asymmetrical, anti-

[34] Case 05-C-1303, "Order Denying Petitions Requesting Suspension of and Hearing on Tariff Filings" (issued and effective December 6, 2005), at 6.

[35] *Competition III Order* at 67.

[36] *Id.*

competitive regulatory barrier standing in the way of Verizon's ability to respond rapidly to price changes in a competitive market. The beneficiaries of such delay — and of the resulting constraints on price decreases — would be Verizon's competitors; the victims, other than Verizon itself, would be end-user customers.

Third, the anti-consumer and anti-competitive aspects of imputation requirements would be increased by the fact that price floors are necessarily based on averages of costs and revenues across geographies and customers, and will thus prevent price reductions in some circumstances where the reduced prices would be both pro-competitive and pro-consumer.

Fourth, imputation restraints would create no competitive benefits that could outweigh their significant costs. As already discussed, the likelihood of an imputation violation is low or non-existent in a market characterized by robust, facilities-based competition. In such a market, there are no bottleneck inputs that would enable a price squeeze to/ succeed, and advance imputation determinations would thus be a remedy in search of a problem. Moreover, anti-competitive schemes based on under-pricing of retail services — *i.e.*, the type of scheme that imputation rules are designed to prevent — cannot be sustained unless the firm engaging in such predation has the ability to recoup (through subsequent overpricing) the retail profits that it lost in carrying out the scheme. However, such recoupment is virtually impossible in a market that is robustly and ubiquitously competitive.[37]

[37] As one recent treatise notes:

> It is generally recognized by the courts that predatory pricing schemes involve a two-phase process. In the first stage, the defendant sets prices below its marginal cost hoping to eliminate rivals and increase its share of the market. The second stage is the "recoupment" period, when low prices charged in the initial stage of the scheme eventually give way to high prices as the predator cements its monopoly power and seeks to recoup its earlier losses. The latter recoupment phase is critical to the success of the endeavor. As the Supreme Court has stated: "The success of any predatory scheme depends on *maintaining* monopoly power for a long enough period of time to both recoup the predator's losses and to harvest some additional gain."
>
> Based on such reasoning, "predatory pricing must involve, in addition to some level of below-cost pricing that is harmful to competition, the rational expectation of later realizing monopoly profits. The failure to show this additional aspect is fatal." The cases suggest that an objective expectation of recoupment may be lacking where market structure renders the recoupment of lost

(continued ...)

Finally, even if it were assumed — incorrectly — that bottleneck inputs to retail business services still existed, and that Verizon was a monopoly provider of such inputs, Verizon could exploit that monopoly only if it included more above-cost contribution per unit in its bottleneck inputs than it included in its retail services. This, among other things, is the minimum requirement for a "price squeeze."[38] But if such a contribution disparity *did* exist, then it would be more profitable for Verizon if it simply stopped providing the relevant retail services. (In that case, the retail units it had formerly sold would instead be provided instead by its retail competitors, which would then, *ex hypothesi*, need to purchase more units of bottleneck inputs from Verizon. Thus, by exiting the retail market, Verizon would lose contribution from the sale of retail units, but would gain a greater level of contribution from additional sales of units of bottleneck inputs.) Thus, economic realities would either push Verizon to maintain equal contribution levels in its retail and input prices — even if explicit regulation did not — or

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(...continued)

> profits unlikely or very risky. This may be the case, for example, where barriers to entry are low or where market conditions are such that competitors are not likely to be driven out of business. Indeed, the Seventh Circuit has held that recoupment is unlikely to occur unless the defendant already possesses monopoly power. The court stated that: "If he does not have such power, he will not be able to recoup the losses sustained in pricing below cost by later raising his price above the competitive level."
>
> The approach of using the recoupment issue as an additional "filter" for predatory pricing claims has become increasingly influential in the last few years.

(ANTITRUST LAWS AND TRADE REGULATION (2d ed. 2005), § 27.02[2] (footnotes omitted).)

In view of these considerations, the Supreme Court has ruled that a showing of below-cost pricing is a necessary, but not a sufficient, basis for a predatory pricing claim; such a claim *also* requires a showing of a likelihood of recoupment. (*Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 222, 224 (1993).) Economic theory is in accord. (*See, e.g.*, William J. Baumol & J. Gregory Sidak, TOWARD COMPETITION IN LOCAL TELEPHONY (1994), at 63.)

Because price-squeeze schemes require the predatory firm to forego retail profits in the short run in order to eliminate competitors in the long-run, these cogent conclusions apply to imputation violations to the same extent as they apply to classic predatory (*i.e.*, below marginal cost) pricing schemes.

[38] *See* Baumol & Sidak, *supra*, at 111; Kahn, Alfred E., LETTING GO: DEREGULATING THE PROCESS OF DEREGULATION (1998), at 109-13. This is essentially the price-floor rule that was adopted by the Commission in 1995 in approving the new-service pricing provisions of Verizon's Performance Regulation Plan.

those realities would eliminate the price squeeze problem in a different way by inducing the company to withdraw as a competitor in the retail market. In neither case would Verizon have any incentive or ability to unfairly undercut its competitors in the retail market.

For all of these reasons, Verizon's pricing flexibility should not be subject to any price-floor rules.

IV. RATIONALE FOR UPWARD PRICING FLEXIBILITY

A. In General

The Commission has a responsibility under § 91(1) of the Public Service Law to ensure that regulated rates remain "just and reasonable." However, it has consistently recognized that this standard does not necessarily require it to conduct detailed substantive reviews of individual rate changes, including rate increases. Rather, under the Public Service Law it may rationally conclude that the competitive market itself provides a restraint on price increases that is sufficient to ensure that rates remain just and reasonable. As noted above, as early as 1996 the Commission reaffirmed its prior policy of granting pricing flexibility commensurate with the existence of competition, and specifically held that the ability to increase prices by up to 25% per year, on one day's notice, was reasonable for competitive services even when provided by "dominant" carriers. In the *Competition III Order*, the Commission went further and concluded that the competitive environment then existing for non-basic retail residential services was sufficient to support *unlimited* flexible-price increases on one day's notice.

As noted above, the two 2006 NERA reports, and the supplemental material provided in Attachment 2, demonstrate that competition in the market for retail business services is robust, pervasive and permanently established in New York, and amply justifies even the Full-Flex pricing considered in *Competition III* itself, and *a fortiori* the more modest form of pricing flexibility at issue here. This conclusion is reaffirmed by the quantitative revenue/elasticity study described in Section IV(B) below and in Attachment 2, which shows that significant price increases could not be sustained in the long run in the competitive environment for business services that exists in New York.

Moreover, Verizon's financial position independently justifies a degree of upward pricing flexibility. Section 97(1) of the Public Service Law admonishes the Commission to set rates "with due regard, among other things, to a *reasonable average return* upon the value of the property actually used in the public service and to the necessity of making reservation out of income for surplus and contingencies . . . ." (Emphasis supplied.) As already noted, Verizon's average return is far from any level that can possibly be considered "reasonable" — indeed, it is negative. The determination of whether rates are just and reasonable requires consideration of all affected interests, not just the interest of customers in low rates. The financial viability of Verizon — one of New York's largest employers and taxpayers, and a company that has embarked on a substantial program of investing in the state through upgrades to its telecommunications infrastructure — is an additional factor that the Commission can and should take into account in determining whether flexibility to increase prices would be just and reasonable under the Public Service Law.

Upward pricing flexibility is also supported by Staff's recent white paper on a "Framework for Regulatory Relief," submitted in Case 07-C-0349.[39] The White Paper was prepared in connection with the requests of numerous independent incumbent LECs for pricing flexibility for residence services similar to the Full-Flex pricing granted to Verizon in the *Competition III* proceeding. It "proposes a framework comprised of four dimensions which, when taken together, show the extent to which a company is challenged by, and has responded to, competitive pressures, as well as how it is performing financially and operationally."[40] Staff concluded that Verizon met the White Paper's criteria for pricing flexibility for residence services. It should be noted, however, that Staff's proposed framework, like the Commission's *Competition III* analysis, was more stringent than would be appropriate for purposes of this proceeding, because it was intended to apply to requests for *Full Flex* pricing, not the more modest form

[39] Case 07-C-0349, "Framework for Regulatory Relief: A White Paper Prepared by the State of New York Department of Public Service Staff" (April 18, 2007) (the "White Paper").

[40] White Paper at 10.

of pricing flexibility at issue here. It was also intended primarily if not exclusively to apply to independent telcos other than Frontier of Rochester (*i.e.*, the companies that had *not* obtained pricing relief in *Competition III*) — companies that are very differently situated than Verizon with respect to competition, finances, regulatory framework, and other matters. Moreover, the White Paper is at this point just a Staff proposal that will be reviewed by the Commission in light of comments to be submitted by the parties. Nevertheless, the fact that Verizon satisfied the criteria set forth by Staff — and satisfies them as well with respect to business services — supports the relief requested by Verizon in this filing.

First, the White Paper analyzed "competitive presence in a company's franchise area." It did so using an elasticity model "to determine which companies could raise revenues by simply raising their rates. Many [including Verizon] could not, as the corresponding revenue loss due to customers migrating to competitors would outweigh any revenue gains from the rate increase."[41] As discussed in greater detail in Section IV(B), below, Verizon has prepared, and is submitting together with this filing, a revenue/elasticity analysis that applies the White Paper's approach to competitive data relating to business services. That analysis reaches precisely the same conclusion with respect to Verizon's retail business services that Staff and the Commission have already reached with respect to the company's residence services: that those services are subject to competitive price constraints.

Second, the White Paper examines the companies' "financial performance" in terms of "two primary financial performance indicators," change in revenues, and return on equity.[42] Staff "recommend[ed] [that] pricing flexibility be granted to companies that have more than 1% annual loss in revenues <u>and</u> earnings below 5%."[43] Verizon met both of these tests; in Table 6 of the White Paper Staff reports that Verizon's Compound Annual Growth Rate for revenues for the period 2002-2005 was

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[41] *Id.* at 11.

[42] *Id.* at 19.

[43] *Id.* at 21.

negative 5.08% and that its 2005 regulated ROE was *negative* 56.18%. Although an ROE figure cannot readily be calculated for Verizon's business services, it is nevertheless clear that competitive losses of business customers, lines, and usage are an important contributing factor to the financial performance indicators noted by Staff. This is demonstrated by the accompanying report on the state of competition for business services in New York, which notes Verizon's substantial, continuing losses of access lines and revenues.

Third, Staff considered service quality and network modernization as "indicators that reflect the level of a company's continued investment in its network."[44] Network investment is a generic indicator that cannot be broken down by line of business, so no supplement is required here to the White Paper analysis. As the Commission is well aware, in recent years Verizon has been investing substantial sums — notwithstanding its negative net income, return, and ROE — in upgrading its network infrastructure in New York.

With respect to service quality, Staff's analysis focused on the CTRR metric, and noted that "the Commission would look to those companies that maintained an average CTRR of 3.34 or less in at least 90% of their reporting entities on a rolling basis to be granted pricing flexibility, or other regulatory relief."[45] Staff concluded that Verizon met this test. It should be noted that Verizon's CTRR for business lines is significantly lower than the CTRR for residence lines or for aggregate access lines.

Finally, Staff analyzed the companies' Cost Per Access Line ("CPAL") — as a measure of operating efficiency —and stated that "more investigation is necessary before we grant a company with a very high unexplained CPAL (i.e., unexplained CPAL>$20) residential pricing flexibility, or other regulatory relief. Such a company should make efforts to get its costs in line, to show it is effectively

---

[44] *Id.* at 23.

[45] *Id.* at 26.

managing its business and is capable of surviving in the face of competition."[46] Verizon passed this test. Again, this test focuses on company-wide data that are not amenable to re-analysis on a line of business basis.

In short, Verizon satisfies the pricing flexibility requirements established both by the *Competition III* order and the Staff White Paper, as applied to the company's retail business services.

B. REVENUE/ELASTICITY ANALYSIS

The Staff White Paper presented an analytical framework for estimating the impact on a company's revenues of a 5% increase in prices. As already noted, the Commission has solicited comments on that framework in Case 07-C-0349,[47] and it thus has not yet been formally adopted by the Commission. Verizon believes that the framework is unduly conservative. Nevertheless, as we show below, applying the framework to retail business services in Verizon's service area in New York supports the company's request for additional pricing flexibility for such services.

Staff's analysis considered separately customers who were considered to have competitive options, and those that were considered not to have such options, and assigned a different price elasticity of demand to each group.[48] An elasticity of – 0.5 was assumed for customers without options. For customers with options, six factors were evaluated for each of the companies being studied.[49] Particular ranges for each factor were viewed as consistent with price elasticities of – 2.0, – 1.5, or – 1.1, respectively. (For example, an access line density of greater than 100/square mile was considered consistent with an elasticity of –2.0. A density of less than 75/square mile was deemed to support an

[46] *Id.* at 32.

[47] Case 07-C-0349, "Notice Soliciting Comments" (issued April 20, 2007).

[48] In the *Competition III* proceeding, Staff determined that 97% of Verizon's residence customers had competitive options, defined as the availability of at least two intermodal alternatives in the customer's wire center.

[49] The parameters were (1) growth rate for access lines; (2) growth rate for MOUs; (3) % wireless coverage; (4) % cable availability; (5) access line density (lines/square-mile); and (6) the ratio of the company's residential service rate to the rate charged by cable competitors.

elasticity of – 1.1.) Thus, six elasticity estimates would be assigned to any particular company, each based on the value of one of the six factors for that company. These six numbers were averaged to arrive at an overall elasticity estimate.

Staff used the estimated elasticities, together with an estimate of average revenue per access line and the numbers of customers with and without options, to determine the revenue impact on each of the companies it was studying of a 5% price increase. A company was deemed to be subject to competitive price discipline if the estimated revenue impact was negative, and if it exceeded 2.5%.

Verizon applied Staff's approach to the issues raised by this filing as follows:

1. Option Estimates. As noted previously, Staff determined in *Competition III* that some 97% of Verizon's *residence* customers have competitive options. The Appendix to Attachment 2 describes a highly conservative analysis that estimates the percentage of business customers who can be deemed to have access to competitive options, based on wire-center specific data. For sensitivity-analysis purposes, different criteria for considering the availability of options are considered, resulting in a range of "option" estimates.

2. Elasticity. As described in Attachment 2, Staff''s six-factor test yields an assumed elasticity for Verizon business services of – 2.0 for customers with competitive options, and – 0.5 for customers deemed to be without competitive options.

3. Revenues Per Line. Verizon utilized Staff's $50/access line as a reasonable figure for per-line revenues from voice services provided to business customers.

Using the assumptions set forth above, Verizon's analysis clearly demonstrates that a hypothetical price increase of 5% would, in the long run, result in a revenue reduction of more than 2.5% for the entire range of "option" estimates.

V. CONCLUSION

For the reasons set forth above and in the accompanying report (Attachment 2), the Commission should allow Verizon's business pricing flexibility tariff to go into effect as scheduled.

Respectfully submitted,

Joseph A. Post

JOSEPH A. POST
140 West Street — 27th Floor
New York, New York 10007-2109
(212) 321-8126

Counsel for Verizon New York Inc.

May 21, 2007

REDACTED VERSION

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

Tariff Filing of Verizon New York Inc. to Implement Pricing Flexibility for Non-Basic Services	**Case 06-C-0897**

VERIZON NEW YORK INC. TARIFF FILING TO IMPLEMENT LIMITED PRICING FLEXIBILITY FOR RETAIL BUSINESS SERVICES

ATTACHMENT 2

SUPPLEMENTAL REPORT ON COMPETITION FOR BUSINESS SERVICES IN NEW YORK

PREPARED BY PAUL B. VASINGTON

May 21, 2007

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ATTACHMENT 2

SUPPLEMENTAL REPORT ON COMPETITION FOR BUSINESS SERVICES IN NEW YORK

I. INTRODUCTION

In 2006, Verizon New York Inc. ("Verizon") demonstrated that the market for retail business services in New York is fully competitive and on that basis requested "Full-Flex" pricing flexibility for such services. In support of its request, Verizon submitted two reports prepared by National Economic Research Associates, Inc. ("NERA"). In those reports, NERA reached the following conclusions, among others (footnotes omitted):

> In addition to the numerous wireline CLECs that serve business customers around the state, cable companies such as Cablevision, Time Warner, Comcast, and RCN have deployed broadband and telephony-capable networks throughout the state and have experienced great success in attracting customers to their bundled products. Wireless networks have a nearly ubiquitous reach in areas where business lines are concentrated, and businesses can replace and in some cases have replaced wireline service with wireless, both through line substitution and usage substitution. The spread of broadband network access throughout New York enables customers to receive services from numerous independent VoIP providers such as Vonage and Skype.
>
> The presence of these facilities-based alternatives, together with the availability of resold wireline services, unbundled loops and transport, and Verizon's Wholesale Advantage product, mean that the market for telecommunications services in New York is effectively contestable. Irrespective of their current shares of customers, revenue or access lines, competitors can readily enter the market or expand their service offerings to new customers in new geographic areas in response to above-market pricing, without incurring additional sunk network costs.

> These industry developments have resulted in dramatic losses of business access lines, customers and revenue to Verizon. According to FCC data, competitive providers reported that they served over 1.74 million business access lines in the State as of year-end 2005. The FCC data also show that incumbent local exchange carrier ("ILEC") business lines have been declining as competitors have increased their own line counts over the last five years. Verizon's own data confirm that the company has lost substantial numbers of business lines in every area of the state, and that competitors have grown rapidly — primarily through the use of their own facilities. Even these data understate the degree of competition faced by Verizon because they capture only competition from CLECs and cable telephony: they thus do not reflect the full scope of current and potential intermodal competition. In particular, they do not reflect gains by independent, or "over the top," VoIP providers or by mobile wireless carriers, and they do not reflect potential future gains by these technologies or by emerging services such as WiMAX and broadband over power lines . . . . These losses of significant amounts of Verizon business lines and business services show that there are no significant barriers to entering the market or expanding the supply of business services.
>
> . . . Our analysis shows that:
>
> - Facilities that can be used for the provision of competitive business services are available ubiquitously. Using one or more of these "competitive enablers," Verizon's competitors provide service to business customers in every MSA in New York. . . .[[1]]
>
> - The alternative service providers in the retail business market include substantial companies with significant strategic resources that are well able to compete with Verizon. They offer services targeted to a diverse set of business customers, including small- and medium-sized establishments. Indeed, a recent Reuters article characterized cable competitors as targeting the "smaller enterprises first."
>
> - Other emerging competitive alternatives such as WiMAX and BPL promise even stronger, more widespread facilities-based competition in the very near future. Our analysis shows that 75 percent of businesses in New York are covered by broadband wireless services.
>
> This analysis of intermodal alternatives is corroborated by the fact that Verizon has actually lost substantial numbers of business access lines in New York. These losses clearly reflect losses to traditional and intermodal competitors because they have occurred during a period of growing overall demand for business communications services in New York. Indeed, the data show that Verizon's wireline and intermodal competitors are achieving rapid growth. Further:

[1] An MSA is defined as an area that has at least one urbanized area of 50,000 or more population, plus adjacent territory that has a high degree of social and economic integration. In NERA's original tables, and in the revised version of certain of those tables that appear here, "Other" refers to geographic areas served by Verizon that do not fall within an MSA ("No MSA") and includes lines that could not be assigned to an MSA.

- The majority of this competition is facilities-based — *e.g.*, competition from cable companies using their own networks, wireline competitors using their own switches and (in many cases) their own access lines or circuits, and VoIP providers utilizing a variety of broadband networks deployed by competing providers (as well as by Verizon).
- The data show that Verizon's business line losses and corresponding growth by competitors are occurring in every area of the State served by Verizon, not just in the Metro LATA and not just in urbanized areas of the state.

The competitive trends and market facts identified in the NERA reports remain in place today. In particular, industry analysts and market participants continue to view the business market as increasingly competitive, which confirms the findings in last year's NERA reports, and Verizon's line losses for business customers in New York have continued through 2006. Also, we provide in this report a quantitative "elasticity" analysis — based on a revenue effects model recently developed by Staff — demonstrating Verizon's lack of market power and its inability to generate sustained revenue increases by raising retail business prices.

II. COMPETITIVE TRENDS AND MARKET FACTS CONTINUE TO DEMONSTRATE THAT THE MARKET FOR RETAIL BUSINESS SERVICES IN NEW YORK IS VIGOROUSLY COMPETITIVE

New York is one of — if not the — most competitive markets for business services in the country. Yet, while a number of other states have granted business-service pricing flexibility to incumbent local exchange carriers, Verizon remains subject to significant constraints on how it prices its business services in New York. Moreover, Verizon's competitors include cable and VoIP providers that are currently not subject to price regulation by the Commission, as well as traditional wireline CLECs that are subject to far lighter regulation than Verizon. The facts do not warrant this disparate treatment.

As Verizon demonstrated last year, the retail business market in New York is highly competitive. Enterprise market customers[2] in New York are served by a diverse group of competitive suppliers,

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[2] For internal reporting purposes, Verizon defines Enterprise Customers as those customers that spend at least $100,000 per year with Verizon.

including (1) interexchange carriers, (2) network service providers, such as AT&T and BT, (3) systems integrators, such as IBM, (4) equipment providers, such as Cisco and Avaya that provide and manage deployment of private network and VoIP equipment for virtual private network ("VPN") services, (5) competitive local exchange carriers ("CLECs"), (6) data local exchange carriers ("DLECs"), and (7) IP application providers.

Small and medium-sized business ("SMB") customers also are served by an array of competitors, including (1) wireline CLECs that serve business customers around the state, (2) cable companies such as Cablevision, Time Warner, Comcast, and RCN, (3) wireless network providers, (4) independent VoIP providers such as Vonage and Skype, and (4) CLEC resellers that use Verizon's resold wireline services, unbundled loops and transport, and Wholesale Advantage product.

In this filing, we provide confirmation that the trends and market facts identified in the NERA reports continue today.

A. RETAIL BUSINESS CUSTOMERS IN NEW YORK HAVE COMPETITIVE ALTERNATIVES

1. Cable Competition for Business Customers

The NERA Report noted that "[c]able companies have made massive expenditures to upgrade their formerly limited video distribution networks to provide advanced two-way communications services using Internet Protocol technology to residence and business customers," and that they "hold themselves out to provide services to business customers, and the data show that cable companies serve a large and increasing number of business access lines in New York."[3] Since that time, cable companies have continued to roll out their business services and tout their abilities to grow in that market. Updating figures from the NERA Report, the two major cable companies in New York had about **[[BEGIN PROPRIETARY]]** **[[END PROPRIETARY]]** business switched access lines (as measured by E911 listings) at year-end 2006, which accounts for about **[[BEGIN PROPRIETARY]]** **[[END**

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[3] NERA Report at 4, 7.

PROPRIETARY]] percent of the **[[BEGIN PROPRIETARY]]** **[[END PROPRIETARY]]** total business lines served by CLECs, as measured by E911 listings.

In its most recent 10-K report, Cablevision described its traditional wireline business services and network infrastructure, most of which is located and focused in the New York market:[4]

> Through Optimum Lightpath, a business broadband service provider, we provide telecommunications services to the business market in the greater New York City metropolitan area. Lightpath provides converged data, Internet and voice solutions to mid-sized and large businesses, hospital systems, municipalities, and school systems.
>
> Optimum Lightpath has built an advanced fiber optic network extending more than 2,700 route miles (131,000 fiber miles) throughout the New York Metropolitan area. Optimum Lightpath provides scalable advanced Metro Ethernet services that support a variety of business applications …
>
> As of December 31, 2006, Lightpath serviced over 2,000 buildings with approximately 127,000 access lines.[5]

Cablevision Optimum Lightpath's capital expenditures in the first quarter of 2007 were $12,190,000, which is 43% greater than the first quarter of 2006.[6]

Similarly, Time Warner describes its business service plans in its most recent 10-K:

> *Time Warner Cable Business Class.* Time Warner Cable offers commercial customers a variety of high-speed data services, including Internet access, website hosting and managed security. These services are offered to a broad range of businesses and are marketed under the "Time Warner Cable Business Class" brand.[7]

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[4] As noted in the NERA report and below, Cablevision is also offering voice and broadband service to small and medium-sized business customers over its cable network, and is planning on expanding that offering.

[5] 2006 Cablevision 10-K at 3.

[6] Cablevision News Release, "Cablevision Systems Corporation Reports First Quarter 2007 Results," May 3, 2007, at 11, available at http://www.cablevision.com/pdf/Q107_earnings.pdf.

[7] 2006 Time Warner 10-K at 12.

> As an adjunct to its existing commercial high-speed data business, TWC intends to introduce a commercial voice service to small- and medium-sized businesses in most of its Legacy Systems during 2007.[8]

Comcast also has identified the SMB market segment as one in which it can effectively compete:

> Brian Roberts has seen the future of business telephony, and for Comcast, it could be no farther than a pizza joint in a town near you.
>
> The Comcast chairman and CEO, speaking at the Citigroup Entertainment, Media & Telecommunications conference in Las Vegas last week, said that the nation's largest cable operator will focus its initial efforts to break into the business communications market on companies with less than 20 employees, like pizza parlors and other ultra-small businesses.
>
> While it might seem a bit odd for a company of Comcast's size 24.1 million customers and estimated 2006 cable revenue of $26.5 billion to focus on the small fries of the business world, Roberts said the small-business segment is ripe for the picking. He said such firms don't have a choice for business phone service, outside of the local incumbent telephone company. "We believe that business is an incredible replacement alternative of the incumbent local-exchange carrier," Roberts said. "And this is an area that has very little to no competition today from a facilities-based provider. Go to really large enterprises we all have many facilities in our large office buildings but if you're a pizza parlor, you pretty much have one choice."
>
> Roberts estimated there are roughly 5 million such small businesses within Comcast's footprint 3 million of them within or near Comcast's existing network representing an annual revenue opportunity of $12 billion to $15 billion.
>
> "We think this is a natural extension of the network that we've already built," Roberts said. Comcast believes that it can capture at least 20% of the small-business phone market in five years, at a total cost of about $3 billion during that period. The company intends to spend about $250 million on commercial telephony in 2007.[9]

Independent industry analysts continue to view cable companies as significant competitors for business customers, particularly in the SMB market segment. According to a recent report by Insight Research Corporation:

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[8] *Id.* at 8.

[9] Mike Farrell, "Comcast Thinking Small," Multichannel News, January 15, 2007. Although the data clearly refutes Mr. Roberts' contention that the small business segment has little or no competition, his statements nevertheless confirm that that market is one that his company is targeting for aggressive competitive initiatives.

> Our analysis suggests that traditional business line losses will occur as a consequence of the substitution of the traditional lines for either a digital subscriber line (DSL) or cable-based telephony. The losses will be most pronounced in the small enterprise segment, with cable-based telephony eroding the overall total business lines that are serviced by the ILECs.[10]
>
> INSIGHT forecasts that 9.9 million lines of the total of 13.3 million business lines to be lost by the ILECs through 2012 will be lost in the small enterprise segment … The capture of 9.9 million small enterprise lines by the [cable multiple system operators] during this period represents a 25 percent penetration of the total small enterprise market over a six year period. … Small enterprise business line loss will translate into a substantial revenue loss for the ILECs.[11]

Independent surveys of business customers also confirm that the business market presents a market opportunity for cable operators:

> The reliance on landline voice services is decreasing, as evidenced by the vast majority of business respondents not projecting much growth of this service over the next two years. In sharp contrast is the anticipated dramatic growth of most other business services, but notably VoIP, distance learning applications and video services. CSG believes that businesses projecting growth in distance learning (collaboration, training, etc.) applications and video services over the next two years presents a market entry opportunity for cable providers.[12]

Cable operators clearly have an optimistic view of their competitive prospects for retail business services, especially in New York:

> For Comcast, it's reportedly \$3 billion to \$5 billion in five to seven years. For Cablevision, it's \$1.5 billion in two years. And for Cox, it's \$1 billion in four years. These are revenue targets cable companies say they can achieve from selling phone, data and other services to corporate customers, large and small. Indeed, cable multisystem operators (MSO) are increasingly investing in and targeting enterprise businesses to broaden their market and take competition with the phone companies beyond the residential market. …
>
> [P]ublished reports quote a Cablevision executive stating that his company is targeting 600,000 businesses in its New York metropolitan area. Cablevision has said it could get a 25% share of a \$5.8 billion business market in its area in two

---

[10] Insight Research Corporation, "Cable Telephony: The Threat to Small Business ILECs Markets, 2007-2012," April 2007, at 4.

[11] *Id.* at 6.

[12] CSG Systems and Frost & Sullivan, Business Services Survey, "Market Barriers and Opportunities for Cable Operators," March 2007, at 2.

> years in part by offering comparable services to AT&T and Verizon at half the price, the report stated.[13]

Similar reports appeared last fall in the Financial Times:

> Business customers, who have for decades been served mainly by large telecoms companies, are starting to have a bigger choice of voice and data service providers as cable operators begin to target this multi-billion dollar market. ...
>
> Cablevision, the cable operator based in the New York area, is also more advanced than Comcast or Time Warner in rolling out its telephony services. It has already started marketing to business customers in its area. ... Cablevision was targeting both [the small and large business] sectors Mr. Rutledge [Cablevision's COO] said, and there was a "substantial opportunity to lower prices."[14]

Cablevision in particular continues to tout its abilities to succeed in the business market, building on what it views as its success in the residential market:

> Cablevision Systems Corp. (NYSE: CVC) today announced that its digital voice-over-cable product, Optimum Voice, has surpassed the one million-customer milestone. The cable industry's first broadly-deployed VoIP service, Optimum Voice has already attracted one-third of Cablevision's cable television customers and more than half of the company's high-speed Internet customers.
>
> * * *
>
> "The strong response to Optimum Voice has positioned Cablevision to pursue its next major growth opportunity – providing Optimum for business voice and data services with the same level of value and reliability to the hundreds of thousands of businesses in our service area," Rutledge added.[15]

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[13] Jim Duffy, "Cable companies intensify enterprise service ambitions; Comcast, Cablevision, Cox, Time Warner and others see multibillion-dollar opportunity," Network World, October 24, 2006.

[14] Paul Taylor and Aline Van Duyn, "Cable companies sense opportunity to make a bundle," Financial Times, September 26, 2006, at 33.

[15] *See* Cablevision News Release, "Cablevision's Optimum Voice Surpasses One Million Customers," July 18, 2006, available at http://cablevision.com/index.jhtml?id=2006_07_18. Five months after issuing this press release highlighting its one-millionth Optimum Voice customer, Cablevision issued another release announcing that it had more than two million Optimum Online customers, including business customers: "The nation's fastest broadly-deployed Internet services for the home — now increasingly chosen by small businesses as well — Optimum Online continues to lead the nation in market acceptance, providing service to 44 percent of the homes passed by Cablevision's fiber-rich network." *See* Cablevision News Release, "Cablevision's Optimum Online Surpasses 2 Million Customers," December 14, 2006, available at http://www.cablevision.com/index.jhtml?id=2006_12_14.

Earlier this month, cable operators described the reasons for their optimism in competing for business customers:

> The big cable operators are branching into the commercial phone market now because the market is vast, the margins are high and they see incumbent telcos as increasingly vulnerable. . . .
>
> The large cable operators also believe they can move into commercial VoIP with little capital spending. They think they can boost commercial data products' take rate and cut churn on business telecom packages.[16]

The NERA report stated that "[c]able companies have made massive expenditures to upgrade their formerly limited video distribution networks to provide advanced two-way communications services using Internet Protocol technology to residence and business customers. The result in New York is reflected in their widespread ability to provide bundles of voice, video, and data services."[17] That ability to use existing plant for providing business services has been widely recognized and is highlighted in a news report on Cablevision Optimum Lightpath's web-site:

> The new battlefield, at least for cable operators, is the business place. ...
>
> For telephone companies, cable is the first competitor that runs its own wires through the battlefield. AT&T, Verizon Communications and smaller providers have been able to largely fend off local competition by making access to their networks as difficult as possible, within legal bounds. But with complete control of their own networks — and lots of costs sunk into building the capacity needed to serve TV customers — cable operators spot a huge opportunity in extending what they do to business communications.
>
> Cablevision Systems, a champion of reaching out to small- and medium-sized companies, sees business communications as a $6 billion opportunity in its footprint, basically the New York City metropolitan area.
>
> If it can split that with the incumbent carriers — primarily Verizon — its annual revenue of $6 billion would increase by 50%.
>
> In the past two years, Cablevision spent months identifying all the businesses on every street that it could target for its communications services. It put 600,000

[16] "Cable Operators Ready Commercial VoIP Launches," Communications Daily, May 10, 2007.

[17] NERA Report at 4-5.

> "serviceable" companies in its database, according to CEO Tom Rutledge — that is, a Cablevision cable ran in front of the business's building.
>
> The company put in place in-bound, outbound and door-to-door sales forces. It created a separate, 24-hour-a-day service center for customer calls. And it began to market services in earnest.
>
> "We're in full battle mode," Rutledge told investors in March at a Banc of America Securities media and entertainment conference in New York.
>
> His most effective weapons? Price and technology.
>
> "Basically, we charge half of what AT&T or Verizon charges for the same service and we provide a lot more sophisticated services, because it's all-IP," Rutledge said. ...[18]

2. Evidence of VoIP and IP-Network Competition

The NERA report described the presence of broadband networks throughout the state and the ways in which VoIP service provides a competitive alternative to Verizon. Recent reports confirm these facts and highlight the growing importance of IP-based networks and services to serve the SMB market segment.

> Moving voice traffic to a voice-over-IP (VoIP) network is cited as a critical initiative by 10% of the North American SMBs that Forrester surveyed, which is more than other telecom initiatives like conferencing consolidation, network outsourcing, or fixed mobile convergence.[19]
>
> The US business market has seen a lot of growth in the areas of Voice over IP (VoIP) and IP VPN (Virtual Private Network) adoption, as well as in convergence of voice, data, and video capabilities over the last couple of years. In-Stat expects these trends to continue for the foreseeable future, with the small business market fueling much of this growth, particularly those businesses in the 50 to 100 employee range.[20]

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[18] *See* Tom Steinert-Threlkeld, "Full Battle Mode: On the Front Lines of Cable's Campaign to Win Over Business," Multichannel News, April 9, 2007, available at http://www.optimumlightpath.com/Interior77-2.html.

[19] Forrester Research, "Marketing Unified Communications To SMBs," April 17, 2007, at 2-3 (footnotes and figures omitted).

[20] In-Stat, "Small Business VoIP, IP VPN, and Convergence Adoption," December 2006, at 1

The increasing importance of IP-based networks and services has created a competitive opportunity for CLECs and non-traditional telecommunications providers in the SMB segment. A small sample of recent announcements confirms the trend towards IP networks that allow new companies to serve customers' telecommunications needs in ways that used to be the sole province of traditional communications providers:

> MegaPath Inc., the leading provider of managed IP voice, data and security services in North America, today announced that Technology Marketing Corporation's (TMC) Communications Solutions (www.tmcnet.com/comsol [http://www.tmcnet.com/comsol]) has named MegaPath's Duet Voice & Data and SecureConnect services as 2006 Product of the Year Awards recipients. Duet Voice & Data low-priced bundle for phone and high-speed Internet access service for businesses is targeted toward small and medium sized companies. For as little as $99 a month for two phone lines and a broadband connection, Duet provides unlimited local and regional calling, unlimited long-distance calling and true business-class Internet access with a 30-day satisfaction guarantee. Duet's basic packages offer savings of 50% or more and similar services from traditional phone companies for up to 16 phone lines and 1.5Mb of Internet access.
>
> About MegaPath
>
> MegaPath is the leading provider of managed IP communications services in North America. MegaPath leverages its wide selection of broadband connectivity, Virtual Private Networks, Voice over IP (VoIP) and security technologies to enable businesses to lower costs, increase security and enhance productivity. Businesses of all sizes can easily and securely communicate between their headquarters, branch offices, retail locations, mobile workers and business partners.[21]

> M5 Networks is the market leader in "Voice as a Service," a breakthrough solution for business phone communications. Industry experts tell us that in ten years, no business will have a phone system – they will acquire phone system capabilities as an on-demand, managed service over the Internet – in other words, Voice as a Service.[22]

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[21] "MegaPath Receives Two 2006 Product of the Year Awards from Communications Solutions," Business Wire, May 8, 2007.

[22] *See* http://www.m5net.com/html.php?page_id=16, accessed May 14, 2007.

> **M5 has a New York metro client base: As of early 2005, we have over 300 clients and over 7,500 end-users in the New York area and have completed over 50 million calls ...**
>
> M5 has carrier-grade facilities: A visit to a facility can be arranged by your M5 phone system consultant.
>
> M5 is financially sound: We are profitable and believe in growing the business one satisfied client at a time.[23]

3. Evidence of Wireless Services as Competitive Alternatives

The NERA Report showed that "[w]ireless demand from business customers has continued to grow," and that "[f]orecasts of business wireless revenues compared with business wireline revenues confirm the increased emphasis on wireless."[24] There have been several significant announcements this year that confirm and amplify the growing presence and importance of wireless service competition in the retail business market.

First, AT&T announced that it would be integrating its traditional wireline business with its rebranded wireless services (following its merger with BellSouth, AT&T has rebranded Cingular as AT&T Wireless):

> On April 18, 2007, AT&T announced the integration of its enterprise mobility offering into its enterprise wireless solutions. This announcement comes just 90 days after the launch of the new AT&T. It provides an example of the continued integration of AT&T's fixed-line business with Cingular. The main message articulated in this announcement is that AT&T is delivering on its vision of simplified customer experience across wireless and wireline. The service provider highlights that enterprise and SMB customers will benefit from a single account team, a single contract, exclusive bundle benefits, and wireless integration into the [virtual private network]. AT&T expects single contracts to be available in the second half of 2007.[25]

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[23] *See* http://www.m5net.com/downloads/pdfs/Intro_to_M5.pdf (emphasis added), accessed May 14, 2007.

[24] NERA Report at 13-14.

[25] IDC, "AT&T Boldly Goes Where No U.S. Carrier Has Gone Before — Integrating Wireline and Wireless Solutions for the Enterprise," Doc #206519, April 2007.

CLECs are beginning to integrate wireless services into their business plans for serving commercial customers. A recent IDC Product Flash highlighted that fact:

> With an offering once available only to large-scale enterprises with a dedicated mobile field force, Cbeyond has lowered the bar, in a good way, for small businesses looking to minimize costs and maximize the ability to respond to customers. Riding a wave of technology innovations that are delivering enterprise-grade services to smaller and smaller organizations, Cbeyond has leveraged its mobile virtual network operator (MVNO) partnership to deliver a flexible communications package. With private network VoIP, broadband, and now mobile phone service offerings, Cbeyond's focus on small businesses is no small matter. With almost 6.8 million businesses with fewer than 10 employees in the United States, this market will continue to have untapped (rather than fulfilled) potential for service providers until business offerings are introduced that provide real benefits, not just repackaged consumer capabilities.
>
> The use of mobile phones by SMBs will be a major growth area for service providers in the next five years as small companies upgrade and expand their telephony equipment. Within the fewer-than-10-employees segment of the SMB market, which accounts for almost 84% of companies in the United States, there is strong use of mobile phones. Just over 84% of these companies are using mobile phones, with 2.6 phones per company. As the cost of moving business out of the office onto mobile devices continues to fall, SMBs will shift more of their spending to mobile solutions. Offers such as pooled minutes over multiple platforms with limited overage penalties will help drive this trend and, potentially, new brand loyalties.[26]

And just this month, The Wall Street Journal reported on the growing importance of in-building wireless services for businesses, which highlights how wireless services are increasingly being used by business customers:

> The increasing reliance on mobile devices for business highlights the growing need for offices to provide dependable wireless connections and call quality, something that many are lacking. The demand has put more pressure on wireless carriers to improve the overall coverage of their networks. But it's also forcing them to solve some problems building by building. Sometimes the carriers pay for the necessary equipment and installation; in other cases, the customer pays.
>
> "In-building cellular systems are becoming more important, particularly as more and more wireless-to-wireless calls are now coming from inside the building," says

[26] "Cbeyond Offers Wireless/Wireline Small Business Solution That Changes Competitive Landscape by Offering Pooled Minutes," IDC Product Flash, February 2006.

> Mary Chan, president of the wireless business group for equipment maker Alcatel-Lucent.[27]

Although the FCC does not break out its subscriber statistics by residential or commercial customers, it is also worth noting that the number of wireless subscribers in New York continues to grow — from 12,634,420 at the end of 2005, to 13,338,040 in June of 2006 — an increase of 5.5% in just six months.[28]

4. CLEC Competition

Traditional wireline CLECs continue to compete effectively in the business market in New York, both by using their own facilities and by resale and leasing network elements from Verizon. The NERA Report demonstrated that collocation is available at Commission-approved rates at almost every wire center in Verizon's service area, and that CLECs have deployed switches in all but two of the MSAs in which Verizon operates.[29]

Even when MCI's access lines are, for purposes of comparative analysis, attributed to Verizon for the years prior to the merger (which of course results in an understatement of the impact of competition), competitors' access lines have increased substantially. By year-end 2006, competitors were serving about **[[BEGIN PROPRIETARY]]** **[[END PROPRIETARY]]** percent of business switched access lines in areas served by Verizon, up from **[[BEGIN PROPRIETARY]]** **[[END PROPRIETARY]]** percent at year-end 2003.

[27] Cheng, Roger, "Inside Job. As businesses rely more on mobile devices, wireless companies are improving their coverage – building by building," The Wall Street Journal, May 14, 2007, at R4.

[28] FCC, Local Telephone Competition: Status as of June 30, 2006, January 2007, Table 14.

[29] NERA Report at 28.

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Verizon's competitors are providing service over a broad geographic area. Table 2 below shows that competitors provide significant levels of service in every MSA that Verizon serves.

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Even as Verizon has lost business access lines consistently across New York MSAs between 2003 and 2006, Verizon's competitors have gained lines, as shown in Table 3.

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Moreover, the facilities-based competitors are not small, competitively insignificant firms: at least **[[BEGIN PROPRIETARY]]** **[[END PROPRIETARY]]** of them served over 100,000 business listings and another **[[BEGIN PROPRIETARY]]** **[[END PROPRIETARY]]** served 20,000 or more business E 911 listings.[30] Verizon competes for business services with at least **[[BEGIN PROPRIETARY]]** **[[END PROPRIETARY]]** firms including cable companies that have large numbers of E911 listings — *i.e.*, 10,000 or more business listings in New York. Each of these carriers has at least one switch serving New York.

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[30] Verizon internal data.

A small sample of recent announcements from CLECs also confirms that CLECs continue to offer competition and expand their activities in New York for business services using both intermodal and traditional wireline business models:

> Broadview Networks, a leading facilities-based communications provider in the Northeast and Mid-Atlantic, today announced its IP-centric network now extends to approximately 80 percent of its target customer base, including the New York City and Boston metro areas. ... "[W]e are excited to deliver prime time services to our small and medium-sized business customers who want the benefit of these value added voice and data services," [said Kenneth Shulman, Broadview Networks' chief technology officer and chief information officer].[31]

> Cordia Corporation (OTCBB: CORG) today [April 18, 2007] announced that it has reached agreement for a long-term extension and restructuring of its Wholesale Advantage Services Agreement with Verizon. With the signing of this agreement, Cordia can continue its plans to grow its existing bundle of local, long distance and broadband telecommunications services in New Jersey, New York, Pennsylvania, Virginia and Maryland as well as expand into additional Verizon service areas. ... Our goal is to continue to gain market share in the Verizon territory by offering our bundled services to consumers and small businesses at competitive rates while providing exceptional customer service.[32]

Independent investment analysts also have recently commented that the business prospects for CLECs who focus on serving the SMB market segment is positive:

> The four companies that we cover, [Cbeyond, Inc.], [Cogent Communications Group, Inc.], [Eschelon Telecom Inc.] and [Time Warner Telecom Inc.], had a solid 2006 growing in double digits by focusing their efforts on the small and midsize business (SMB) segment. We believe that they will continue to execute in 2007 by focusing on this segment (TWTC is more focused on the medium to smaller enterprise customers). We continue to believe that SMB segment remains the most attractive segment of the industry, since it has historically been the weakest market areas for the RBOCs. While the SMB segment also represents a growth opportunity for the RBOCs, we believe that the RBOCs are more focused on wireless (it represents the highest growth opportunity for them), the residential customers (e.g., witness their attempts to get into the video business) and the Fortune 1000 enterprises (they move the revenue needle). As a result, these

[31] Broadview Press Release, "Broadview Networks Deploy Next Generation IP-Centric Network,"August 29, 2006, available at http://www.broadviewnet.com/Press_News/PressRelease.asp?scenario=0&NewsID=10175.

[32] Cordia Press Release, "Cordia Announces Extension of its Wholesale Service Agreement with Verizon Partner Solutions," April 18, 2007, available at http://www.cordiacorp.com/InvestorRelations/investorrelations.asp #.

> [competitive service providers (CSPs)] are either increasing their salesforce and/or entering new markets to take advantage of the situation.
>
> **FAVORABLE REGULATORY ENVIRONMENT.** Several CSPs mentioned to us that the regulatory environment has never been more stable. The mergers of the RBOCs have resulted in several concessions such as special access rate freeze that are positive for the CSPs.[33]

B. VERIZON CONTINUES TO LOSE BUSINESS LINES AND REVENUES

As noted in the NERA Report, Verizon has experienced significant business line losses in New York, throughout the state. The line loss trends identified in the NERA Report have continued through the end of 2006. FCC ARMIS data for Verizon show that the company has lost substantial volumes of single-line and multi-line business lines in New York in the last six years. The number of single-line access lines declined by more than 50 percent, from 316,438 lines in 2000 to only 150,306 lines at the end of 2006. Verizon has also seen substantial losses in the multi-line business customer category—losing 27 percent of those lines in the same period.

Table 4. Verizon Business Lines, 2000-2006

Year	Single Line	Multi-Line	Total
2000	316,438	3,789,114	4,105,552
2001	237,826	3,656,103	3,893,929
2002	222,818	3,822,877	4,045,695
2003	244,477	3,150,980	3,395,457
2004	152,472	3,094,293	3,246,765
2005	151,556	2,940,802	3,092,358
2006	150,306	2,783,902	2,934,208
	-53%	-27%	-29%

Source: ARMIS data.

Verizon data reported to this Commission show a similar pattern. Verizon business line losses have been substantial and have occurred in all four of the New York regions for which the company reports data. Regional data are available on a consistent basis only back to 2001, and these show an average decline of about **[[BEGIN PROPRIETARY]]** **[[END PROPRIETARY]]** percent statewide

[33] Wachovia, "2007 Competitive Service Provider Outlook," February 2, 2007, at 2.

and of at least **[[BEGIN PROPRIETARY]] [[END PROPRIETARY]]** percent in every territorial division reported to the Commission in Section 61 of the Annual Reports. The overall average decline in business access lines for Verizon from 2000 to 2006 was approximately **[[BEGIN PROPRIETARY]] [[END PROPRIETARY]]** percent in these data.

In addition, Verizon's internal data show that the company has lost business access lines in different customer size categories — *i.e.*, lines serving small and mid-sized business customers ("General Business" customers) and lines serving larger "Enterprise" customers both declined by substantial amounts.[34] Between December 2001 and December 2006, General Business lines declined by about **[[BEGIN PROPRIETARY]] [[END PROPRIETARY]]** percent and Enterprise lines declined by about **[[BEGIN PROPRIETARY]] [[END PROPRIETARY]]** percent.[35]

While competition for business customers is not necessarily uniform across the geography of New York, competition is clearly *present* in every part of Verizon's territory. Because Verizon is proposing to apply the uniformity rule to its flexible pricing for business services, uneven levels of competition in differing geographic areas will have no practical impact. Competition in the most dense urban zones will discipline prices in the least competitive areas of the state. Nevertheless, it is worth updating information about the extent of competition throughout the state.

Between 2000-2006 Verizon business switched access lines declined by at least **[[BEGIN PROPRIETARY]] [[END PROPRIETARY]]** percent in every MSA that it serves, and by **[[BEGIN PROPRIETARY]] [[END PROPRIETARY]]** percent in rural areas (*i.e.*, areas outside of MSAs) in its New York service area. As we show below, the existence of robust competition for business services even in rural areas is confirmed by data on competitive line counts.

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[34] For internal reporting purposes, Verizon defines Enterprise Customers as those customers that spend at least $100,000 per year with Verizon while General Customers spend less than that amount.

[35] Verizon internal data.

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In last year's proceeding, certain parties argued that Verizon's loss of business switched access lines did not represent competitive losses because the company experienced growth in special access circuits. Verizon addressed these arguments in the NERA Supplemental Report. To reiterate, while some business customers undoubtedly have replaced some Verizon switched access lines with Verizon special access circuits, there are several reasons why the growth in special access circuits actually confirms Verizon's demonstration that the retail business market is sufficiently competitive:

First, the majority of Verizon's non-switched service revenues arise from sales to other telecommunications carriers who use the services in combination with other inputs to provide retail services to customers — typically business or government customers — in competition with Verizon's retail business services. Figure 1 below shows that wholesale non-switched revenues have been growing between 1Q04 and 4Q06 while retail non-switched revenues have decreased during the time period.[36] By indexing both series to 1Q04 wholesale revenues, Figure 1 also shows that retail non-switched revenues accounted for a small and decreasing proportion of wholesale revenues during the 1Q04 to 4Q06 period.[37]

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(Figure 1 includes sales to MCI entities in the wholesale category, consistent with the presentation of this information in the NERA report, which covered only the pre-merger period. If the chart is restated with sales to MCI omitted from the wholesale category for all years, and again

[36] The first value for the retail index is the ratio of retail to wholesale revenues, and subsequent periods are pegged to that initial value. Thus, the index shows the same rate of change that would be computed using a traditional retail revenue index beginning at 100. By calculating the index in this manner, it also provides information on the ratio of retail to wholesale revenues.

[37] Retail refers to ILEC retail, and excludes non-switched revenues from the former MCI. Wholesale refers to ILEC wholesale, and includes non-switched revenues received from Verizon affiliates, including the former MCI.

normalizing the initial entry to 100, the trends shown by the original chart are still apparent, as is shown in Figure 2.)

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Second, non-switched circuits are not a substitute for many business customers whose telecommunications demands do not justify the expenditures required to obtain such circuits. The demand for non-switched access services is a function of a company's typical calling and data volume, and it would not be economically rational for most small businesses with relatively few lines to purchase special access services.

Third, the FCC has found that interstate special access is sufficiently competitive to justify pricing flexibility and that the price of such access is constrained by a commitment made in the Verizon-MCI merger. Thus, Verizon has no ability to manipulate the price of interstate non-switched services, so that for economic purposes, such services should be treated as competing with intrastate switched and non-switched services in determining whether Verizon has the ability to control the prices of such services.

Parties in last year's case also criticized Verizon's use of E911 data to demonstrate line loss, mainly on the grounds that such data are not a reliable indicator of line losses. Again Verizon demonstrated in the NERA Supplemental Report that such concerns are unfounded. The use of E911 data is an accurate indicator of the amount of competition that Verizon faces in the business marketplace, regardless of whether it precisely measures loss of business access lines.[38] Thus, it is reasonable to use E911 as part of a competitive analysis, and regulators have consistently relied upon E911 listings in their assessments of competitive activity. Policymakers have relied on E911 data because E911 listings provide a relevant and useful measure of competitive activity. When a CLEC utilizes its own switch to serve its customers, information on customer location and the phone number must be entered into the E911 database. The E911 database thus shows customer information as well as the name of the carrier that owns the switch providing the service. Thus, the E911 listings provide a meaningful picture of the amount of competition that Verizon faces at a point in time, and they can be used to examine competitive trends over a period of time. Significant increases in CLEC E911 listings imply that CLECs are serving more customers and more lines while significant decreases would indicate the opposite.

C. ELASTICITY MODELS DEMONSTRATE THAT VERIZON CANNOT PROFITABLY INCREASE RETAIL BUSINESS SERVICE PRICES

As discussed in Attachment 1, Verizon has prepared an elasticity/revenue analysis, based on the methodology set forth in Staff's recent White Paper in Case 07-C-0349, as adapted to business services. The analysis shows that Verizon could not sustain long-term increases in the price of business services without sustaining significant revenue losses due to competitive and customer demand response. The

[38] In a proceeding in 2002, the Massachusetts commission was presented with arguments that the E911 database did not accurately count CLEC facilities-based lines and found that "the Department has no substantial evidence that the CLEC facilities-based line counts derived from the E911 database either over or under-state the actual number of CLEC facilities-based business lines in Massachusetts." D.T.E. 01-31-Phase I, Order (dated May 8, 2002), at 84.

analysis is set forth in the spreadsheet provided as an Appendix to this Attachment 2. Verizon used the following parameters in its analysis:

- Assumed revenue per business line: $50/month.
- Assumed price elasticity of demand for customers deemed to be without options: – 0.5.
- Assumed price elasticity of demand for customers with options: – 2.0.
- Hypothetical price increase: 5%.
- Revenue-change "hurdle" for demonstrating competitive discipline: – 2.5%.
- Percentage of customers with options: alternative estimates based on data in NERA reports.

The elasticity for customers with options was based on the six-factor analysis developed in Staff's White Paper, as follows:[39]

[39] *See* Staff White Paper, Appendix II, page 3 of 3, which sets for the sources of the data utilized in the Staff elasticity model.

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[40] Specific data for business MOU is not included in the Annual Report.

[41] *See* the "options" analysis provided in the "Summary" tab of the Appendix, lines 11-12 and 17-18 (wireless and cable coverage, respectively). It should be noted that Verizon evaluated cable coverage based on *actual* provision of service to one or more business customers in the wire center. Given the *Competition III Order*'s emphasis on contestable market analysis, this measure of actual competition is conservative.

[42] "Density" is relevant because it "is correlated with lower costs to serve[;] the greater the service territory density, the more likely competitive wireless carriers and cable companies will be to build out their networks." (Staff White Paper at 14.) Thus, density, for purposes of Staff's analysis, is a measure of the economic characteristics of a particular service area. Accordingly, and to ensure consistency with the density breakpoints used in Staff's analysis, Verizon used the Schedule 61 data for total access lines, not just business access lines.

It is important to note, however, that the use of Verizon access lines, as shown in Schedule 61, is a highly conservative approach, since a true assessment of density as an indicator of competitive opportunity should include not only Verizon's access lines but also lines of Verizon's wireline and intermodal competitors, on a channels or voice-grade equivalent basis. (Any other approach would lead to the paradoxical result that as competition expands, the density used in the analysis, and therefore the absolute value of the assumed elasticity, would decrease rather than increase.)

[43] Cablevision's Optimum Voice for Business offers Optimum Online customers unlimited calling and 12 calling features for a flat monthly charge of $34.95 (1-3 lines) or $29.95 (4-8 lines). (*See* http://www.optimum.com/business/ov/pricing.jsp.) Verizon's Freedom for Business rate is well in excess of this level. *See also* the quote from Network World (footnote 13, *supra*), reporting that "Cablevision has said it could get a 25% share of a $5.8 billion business market in its area in two years in part by offering comparable services to AT&T and Verizon at half the price . . . .").

Further validation for using an elasticity of – 2.0 in this analysis is that Staff found that Verizon's elasticity for residential services is – 1.85, and price elasticities for business customers would be expected to be higher than those for residence customers.

As shown in the accompanying spreadsheets, the analysis concludes that a hypothetical 5% price increase would result in the provider *losing* more revenue from its business competitive customers than it would gain from other customers.

III. SUMMARY AND CONCLUSIONS

As demonstrated above and in the NERA reports, competition for retail business services is ubiquitous, robust, and permanently established in New York.

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APPENDIX

ELASTICITY SPREADSHEET

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