

Verizon California Inc.

Financial Statements
As of December 31, 2010 and 2009
and for the years then ended

Verizon California Inc.

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Verizon California Inc.

REPORT OF INDEPENDENT AUDITORS

To The Board of Directors and Shareowner of Verizon California Inc.

We have audited the accompanying balance sheets of Verizon California Inc. (“the Company”), a subsidiary of Verizon Communications Inc., as of December 31, 2010 and 2009, and the related statements of income, changes in shareowner’s investment, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company’s internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Verizon California Inc. at December 31, 2010 and 2009, and the results of its operations and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Ernst + Young LLP

New York, New York
March 30, 2011

Verizon California Inc.

STATEMENTS OF INCOME

(dollars in millions)

Years Ended December 31,	2010	2009
Operating Revenues	\$ 2,876	\$ 2,961
Operating Expenses		
Cost of services and sales (exclusive of items shown below)	973	978
Selling, general and administrative expense	545	819
Depreciation and amortization expense	493	519
Total Operating Expenses	2,011	2,316
Operating Income	865	645
Other income, net	---	1
Interest expense	(66)	(74)
Income Before Provision for Income Taxes	799	572
Provision for income taxes	(352)	(216)
Net Income	\$ 447	\$ 356

See Notes to Financial Statements.

Verizon California Inc.

BALANCE SHEETS

(dollars in millions)

At December 31,	2010	2009
Assets		
Current assets		
Notes receivable from affiliate	\$ 207	\$ ---
Accounts receivable:		
Trade and other, net of allowances for uncollectibles of \$32 and \$33	343	366
Affiliates	100	70
Deferred income taxes	53	48
Deferred charges and other	51	86
Total current assets	<u>754</u>	<u>570</u>
Plant, property and equipment	13,125	13,846
Less accumulated depreciation	<u>8,814</u>	<u>9,410</u>
	<u>4,311</u>	<u>4,436</u>
Prepaid pension asset	2,555	2,535
Other assets	66	64
Total assets	<u>\$ 7,686</u>	<u>\$ 7,605</u>
Liabilities and Shareowner's Investment		
Current liabilities		
Debt maturing within one year:		
Notes payable to affiliates	\$ ---	\$ 1,895
Accounts payable and accrued liabilities:		
Affiliates	130	155
Other	231	166
Other current liabilities	<u>182</u>	<u>186</u>
Total current liabilities	<u>543</u>	<u>2,402</u>
Long-term debt		
Notes payable to affiliates	1,000	1,000
Other	201	201
Employee benefit obligations	795	802
Deferred credits and other liabilities:		
Deferred income taxes	1,580	1,355
Other	<u>122</u>	<u>108</u>
	<u>1,702</u>	<u>1,463</u>
Shareowner's investment		
Common stock - one share, without par value	1,400	1,400
Contributed capital	1,438	177
Reinvested earnings	<u>607</u>	<u>160</u>
Total shareowner's investment	<u>3,445</u>	<u>1,737</u>
Total liabilities and shareowner's investment	<u>\$ 7,686</u>	<u>\$ 7,605</u>

See Notes to Financial Statements.

Verizon California Inc.

STATEMENTS OF CHANGES IN SHAREOWNER'S INVESTMENT

	(dollars in millions)	
Years Ended December 31,	2010	2009
Common Stock		
Balance at beginning of year	\$ 1,400	\$ 1,400
Balance at end of year	<u>1,400</u>	<u>1,400</u>
Contributed Capital		
Balance at beginning of year	177	177
Capital contribution from parent	1,300	---
Return of capital	(39)	---
Balance at end of year	<u>1,438</u>	<u>177</u>
Reinvested Earnings		
Balance at beginning of year	160	991
Net income	447	356
Dividends declared	---	(1,187)
Balance at end of year	<u>607</u>	<u>160</u>
Total Shareowner's Investment	<u>\$ 3,445</u>	<u>\$ 1,737</u>

See Notes to Financial Statements.

Verizon California Inc.

STATEMENTS OF CASH FLOWS

Years Ended December 31,	(dollars in millions)	
	2010	2009
Cash Flow from Operating Activities		
Net income	\$ 447	\$ 356
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	493	519
Deferred income taxes, net	229	66
Employee retirement benefits	27	234
Provision for uncollectible accounts	26	31
Gain on sale of land	(44)	---
Changes in current assets and liabilities:		
Accounts receivable	(38)	(73)
Other current assets	20	56
Accounts payable and accrued liabilities	47	(104)
Other current liabilities	(3)	(44)
Other, net	(66)	(57)
Net cash provided by operating activities	1,138	984
Cash Flows from Investing Activities		
Capital expenditures (including capitalized network software)	(378)	(559)
Purchases of short-term investments	---	(1)
Proceeds from sale of short-term investments	---	12
Proceeds from sale of assets	45	6
Net change in current notes receivable from affiliate	(207)	---
Other, net	(1)	(29)
Net cash used in investing activities	(541)	(571)
Cash Flows from Financing Activities		
Proceeds from borrowings	---	1,000
Principal repayments of borrowings and capital lease obligations	---	(525)
Net change in current notes payable to affiliate	(1,895)	303
Dividends paid	---	(1,187)
Capital contribution from parent	1,300	---
Net change in outstanding checks drawn on controlled disbursement accounts	(2)	(4)
Net cash used in financing activities	(597)	(413)
Net change in cash	---	---
Cash, beginning of year	---	---
Cash, end of year	\$ ---	\$ ---

See Notes to Financial Statements.

Verizon California Inc.

NOTES TO FINANCIAL STATEMENTS

1. DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

Verizon California Inc. (Verizon California or the Company) is a wholly owned subsidiary of GTE Corporation (GTE), which is a wholly owned subsidiary of Verizon Communications Inc. (Verizon). We currently serve a territory consisting of Local Access and Transport Areas (LATA) located in California. We have one reportable segment which provides domestic wireline telecommunications services. We currently provide three basic types of telecommunications services:

- *Exchange telecommunication service* is the transmission of telecommunications among customers located within a local calling area within a LATA. Examples of exchange telecommunications services include switched local residential and business services, local private line voice and data services and Centrex services. We also provide toll services within a LATA (intraLATA long distance).
- *Exchange access service* links a customer's premises and the transmission facilities of other telecommunications carriers, generally interLATA carriers. Examples of exchange access services include switched access and special access services.
- In addition, we also provide fiber-to-the-premises services, operated under the FiOS service mark (FiOS TV), for residential and small business subscribers in certain areas.

The communications services we provide are subject to regulation by the state regulatory commission of California with respect to intrastate rates and services and other matters. The Federal Communications Commission regulates rates that we charge long distance carriers and end-user subscribers for interstate access services.

On May 13, 2009, Verizon announced a definitive agreement with Frontier Communications Corporation (Frontier) that resulted in Verizon establishing a separate entity, known as New Communications Holdings Inc. (Spinco), for the purpose of holding defined assets and liabilities of Verizon's local exchange business and related landline activities in 13 states and parts of California.

On July 1, 2010, after receiving regulatory approval, Verizon completed the spin-off of the shares of Spinco to Verizon stockholders and the merger of Spinco with Frontier, resulting in Verizon stockholders collectively owning approximately 68 percent of Frontier's equity which was outstanding immediately following the merger. Frontier issued approximately 678.5 million shares of Frontier common stock in the aggregate to Verizon stockholders in the merger, and Verizon stockholders received one share of Frontier common stock for every 4.165977 shares of Verizon common stock they owned as of June 7, 2010. Verizon stockholders received cash in lieu of any fraction of a share of Frontier common stock to which they otherwise were entitled.

At the time of the spin-off and the merger, Spinco held defined assets and liabilities of the local exchange business and related landline activities in Arizona, Nevada, as well as a small number of exchanges in California bordering Arizona, Nevada and Oregon, including Internet access and long distance services and broadband video provided to designated customers in those areas. The local exchange business and related landline assets that were not retained by Verizon California at the closing of the Frontier Merger comprised approximately 1% of Verizon California's total revenues for the six-month ended June 30, 2010 and for the year ended December 31, 2009; and approximately 1% and 2% of its operating income for the six-month period ended June 30, 2010 and for the year ended December 31, 2009, respectively.

At the closing of the Frontier merger, Verizon California decreased its Contributed capital by \$39 million to account for assets contributed to Spinco, and subsequently to Frontier. The long-term debt that was previously issued by Verizon California was not affected by the Frontier Merger and remains the obligation of Verizon California.

During 2010 and 2009, Verizon recorded pre-tax charges of \$0.5 billion and \$0.2 billion, respectively, primarily for costs incurred related to network, non-network software and other activities to enable all of the divested markets in the transaction with Frontier to operate on a stand-alone basis subsequent to the closing of the transaction, and professional advisory and legal fees in connection with this transaction. Also included during 2010 are fees related to early extinguishment of debt. The portion of these charges recorded by Verizon California was immaterial.

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Basis of Presentation

We prepare our financial statements using U.S. generally accepted accounting principles (GAAP) which require management to make estimates and assumptions that affect reported amounts and disclosures. Actual results could differ from those estimates. Examples of significant estimates include: the allowance for doubtful accounts, the recoverability of plant, property and equipment, the recoverability of intangible assets and other long-lived assets, unbilled revenues, unrecognized tax benefits, valuation allowances on tax assets, accrued expenses, and pension and postretirement benefit assumptions.

We have evaluated subsequent events through March 30, 2011, the date these financial statements were available to be issued.

We have reclassified certain amounts from prior periods to conform with our current presentation.

Revenue Recognition

We earn revenue based upon usage of our network and facilities and contract fees. In general, fixed monthly fees for voice, video and certain other services are billed one month in advance and recognized when earned. Revenue from services that are not fixed in amount and are based on usage is generally billed in arrears and recognized when such services are provided. When we bundle the equipment with maintenance and monitoring services, we recognize equipment revenue when the equipment is installed in accordance with contractual specifications and ready for the customer's use. Revenue associated with maintenance and monitoring services contracts is accounted for using the percentage-of-completion method based on the ratio of actual costs incurred to total estimated costs of the contract. Expenses associated with each contract are recognized as incurred in connection with the installation of equipment. We use the completed contract method if we cannot estimate the costs with a reasonable degree of reliability.

Installation related fees, along with the associated costs up to, but not exceeding these fees, are deferred and amortized over the customer relationship period.

We report taxes imposed by governmental authorities on revenue-producing transactions between us and our customers on a net basis.

Maintenance and Repairs

We charge the cost of maintenance and repairs, including the cost of replacing minor items not constituting substantial betterments, principally to Cost of services and sales as these costs are incurred.

Trade and Other Accounts Receivable

Trade and other accounts receivable are stated at the amount we expect to collect. We maintain allowances for uncollectible accounts for estimated losses resulting from the inability of our customers to make required payments. In determining these estimates, we consider historical write-offs, the aging of the receivables and other factors, such as overall economic conditions.

Concentrations of Credit Risk

Financial instruments that subject us to concentrations of credit risk consist primarily of trade receivables. Concentrations of credit risk with respect to trade receivables, other than those from AT&T Inc. (AT&T) and Sprint Nextel Corporation (Sprint), are limited due to the large number of customers. We generated revenues from services provided to AT&T and Sprint (primarily network access and billing and collection) of \$109 million and \$46 million in 2010 and \$109 million and \$50 million in 2009, respectively.

While we may be exposed to credit losses due to the nonperformance of our counterparties, we consider this risk remote and do not expect the settlement of these transactions to have a material effect on our results of operations or financial position.

Verizon California Inc.

Notes Receivable

The Financial Services agreement between Verizon Network Funding Corp. (VNFC) and us allows VNFC to collect funds on our behalf. These funds are assigned a variable interest rate and are payable on demand, therefore, the carrying value of the notes receivable approximates their fair market value. As of December 31, 2010, we had notes receivable in the amount of \$207 million from VNFC.

Plant and Depreciation

We record our plant, property and equipment at cost. Depreciation expense is principally based on the composite group remaining life method and straight-line composite rates. This method provides for the recognition of the cost of the remaining net investment in local telephone plant, less anticipated net salvage value, over the remaining asset lives. This method requires the periodic revision of depreciation rates.

The asset lives used by our operations are presented in the following table:

Average Useful Lives (in years)

Buildings	45
Central office equipment	5-11
Outside communications plant	
Copper cable	15
Fiber cable	25
Poles and conduit	30-50
Furniture, vehicles and other	5-15

When we replace, retire or otherwise dispose of depreciable plant used in our local telephone network, we deduct the carrying amount of such plant from the respective accounts and charge it to accumulated depreciation.

We capitalize and depreciate network software purchased or developed along with related plant assets. We also capitalize interest associated with the acquisition or construction of network-related assets. Capitalized interest is reported as a reduction in interest expense and depreciated as part of the cost of network-related assets.

In connection with our ongoing review of the estimated remaining average useful lives of plant, property and equipment, we determined that there were no changes necessary to average useful lives for 2010. We determined effective January 1, 2009 that the average useful lives of fiber cable would be increased to 25 years from 20 to 25 years and the average useful lives of copper cable would be changed to 15 years from 13 to 18 years. As a result, 2009 depreciation expense decreased by \$10 million.

We believe that the current estimated useful asset lives are reasonable, although they are subject to continual review and analysis. In the evaluation of asset lives, multiple factors are considered, including, but not limited to, technology upgrades and enhancements, planned retirements, and the adequacy of reserves.

Long-Lived Assets

Our plant, property and equipment are reviewed for impairment. These assets are tested for recoverability whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. If any indications were present, we would test for recoverability by comparing the carrying amount of the asset to the net undiscounted cash flows expected to be generated from the asset. If those net undiscounted cash flows do not exceed the carrying amount (i.e., the asset is not recoverable), we would perform the next step, which is to determine the fair value of the asset and record an impairment, if any. An impairment charge is recognized for the amount (if any) by which the carrying value of the asset exceeds its fair value.

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Computer Software Costs

We capitalize the cost of internal-use network and non-network software which has a useful life in excess of one year. Subsequent additions, modifications or upgrades to internal-use network and non-network software are capitalized only to the extent that they allow the software to perform a task it previously did not perform. Software maintenance and training costs are expensed in the period in which they are incurred. Also, we capitalize interest associated with the development of internal-use network software.

Intangible Assets

Our intangible assets primarily consist of franchise fees related to obtaining the rights to provide certain services in a local area. Intangible asset amortization expense was not material for the years ended December 31, 2010 and 2009.

Advertising Costs

Costs for advertising products and services as well as other promotional and sponsorship costs are charged to Selling, general and administrative expense in the periods in which they are incurred.

Stock-Based Compensation

We participate in the Verizon Communications Long Term Incentive Plan (the Plan). The Plan permits the granting of stock options, stock appreciation rights, restricted stock, restricted stock units, performance shares, performance stock units and other awards.

Restricted Stock Units

The Plan provides for grants of Restricted Stock Units (RSUs) that generally vest at the end of the third year after the grant. The RSUs granted prior to January 1, 2010 are classified as liability awards because the RSUs will be paid in cash upon vesting. The RSU award liability is measured at its fair value at the end of each reporting period and, therefore, will fluctuate based on the performance of Verizon common stock. The RSUs granted subsequent to January 1, 2010 are classified as equity awards because these RSUs will be paid in Verizon common stock upon vesting. The RSU equity awards are measured using the grant date fair value of Verizon common stock and are not remeasured at the end of each reporting period. Dividend equivalent units are also paid to participants at the time the RSU award is paid, and in the same proportion as the RSU award.

Performance Stock Units

The Plan also provides for grants of Performance Stock Units (PSUs) that generally vest at the end of the third year after the grant. As defined by the Plan, the Human Resources Committee of the Board of Directors of Verizon determines the number of PSUs a participant earns based on the extent to which the corresponding goal has been achieved over the three-year performance cycle. All payments are subject to approval by the Human Resources Committee. The PSUs are classified as liability awards because the PSU awards are paid in cash upon vesting. The PSU award liability is measured at its fair value at the end of each reporting period and, therefore, will fluctuate based on the price of Verizon common stock as well as performance relative to the targets. Dividend equivalent units are also paid to participants at the time that the PSU award is determined and paid, and in the same proportion as the PSU award.

Stock Options

The Plan provides for grants of stock options to participants at an option price per share of 100% of the fair market value of Verizon common stock on the date of grant. Each grant has a 10-year life, vesting equally over a three-year period, starting at the date of the grant. We have not granted new stock options since 2004.

The structure of Verizon's stock incentive plans does not provide for the separate determination of certain disclosures for our company. The required information is provided on a consolidated basis in Verizon's Annual Report on Form 10-K for the year ended December 31, 2010.

After-tax compensation expense for other stock-based compensation included in net income as reported for the years ended December 31, 2010 and 2009 was not material.

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Employee Benefit Plans

We participate in Verizon's benefit plans and the structure of these plans does not provide for the separate disclosure of the related pension and postretirement assets and obligations at a company level. The annual income and expense related to our employees are allocated to the Company based on employee obligations and are included in the statements of income in Cost of services and sales and Selling, general and administrative expenses. The related pension and postretirement benefit asset/obligations have been accumulated over time based on accruals net of payments and termination/settlement charges and are included in Prepaid pension assets and Employee benefit obligations in the balance sheets (see Note 5).

Verizon recognizes a defined benefit postretirement plan's funded status as either an asset or liability on the consolidated balance sheets. Also, Verizon measures any prior service costs and credits that arise during the period as a component of Accumulated other comprehensive income (loss), net of applicable income tax. Because of the structure of the plans, the related adjustments recorded by Verizon to recognize the funded status are not reflected in our balance sheets as of December 31, 2010 or 2009.

We maintain ongoing severance plans for both management and associate employees, which provide benefits to employees that are terminated. The costs for these plans are accounted for under the accounting standards regarding employers' accounting for postemployment benefits. We accrue for severance benefits based on the terms of our severance plan over the estimated service periods of the employees. The accruals are also based on the historical run-rate of actual severances and expectations for future severances. Severance costs are included in Selling, general and administrative expense in our statements of income.

Fair Value Measurements

Fair value of financial and non-financial assets and liabilities is defined as an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. The three-tier hierarchy for inputs used in measuring fair value, which prioritizes the inputs used in the methodologies of measuring fair value for assets and liabilities, is as follows:

Level 1 - Quoted prices in active markets for identical assets or liabilities

Level 2 - Observable inputs other than quoted prices in active markets for identical assets and liabilities

Level 3 - No observable pricing inputs in the market

Financial assets and financial liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurements. Our assessment of the significance of a particular input to the fair value measurements requires judgment, and may affect the valuation of the assets and liabilities being measured and their placement within the fair value hierarchy.

Income Taxes

Verizon and its domestic subsidiaries, including us, file a consolidated federal income tax return. Additionally, we are included in consolidated state income tax returns which are filed by Verizon. For reporting purposes, we calculate and record current and deferred tax expense by applying the accounting standard for accounting for income taxes as if we were a separate taxpayer, with an exception for any benefits of consolidated federal and state filings generated by net operating losses based on our separate return calculation and/or tax credits. For separate states, the Company records valuation allowances against the deferred tax assets and net operating losses if they are not expected to be realized. At December 31, 2010 and December 31, 2009, we had an income tax payable due to Verizon Communications Inc. of \$84 million and \$24 million, respectively.

Our effective tax rate is based on pre-tax income, statutory tax rates, tax laws and regulations and tax planning strategies available to us in the various jurisdictions in which we operate.

Deferred income taxes are provided for temporary differences in the bases between financial statement and income tax assets and liabilities. Deferred income taxes are recalculated annually at tax rates then in effect. We record valuation allowances to reduce our deferred tax assets to the amount that is more likely than not to be realized.

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We use a two-step approach for recognizing and measuring tax benefits taken or expected to be taken in a tax return. The first step is recognition: we determine whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, we presume that the position will be examined by the appropriate taxing authority that has full knowledge of all relevant information. The second step is measurement: a tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. Differences between tax positions taken in a tax return and amounts recognized in the financial statements will generally result in one or more of the following: an increase in a liability for income taxes payable, a reduction of an income tax refund receivable, a reduction in a deferred tax asset, or an increase in a deferred tax liability.

Significant management judgment is required in evaluating our tax positions and in determining our effective tax rate.

Recent Accounting Standards

In January 1, 2011, we prospectively adopted the accounting standard update regarding revenue recognition for multiple deliverable arrangements. This method allows a vendor to allocate revenue in an arrangement using its best estimate of selling price if neither vendor specific objective evidence nor third party evidence of selling price exists. Accordingly, the residual method of revenue allocation is no longer permissible. We are currently evaluating the impact that this standard update will have in our financial statements.

In January 1, 2011, we prospectively adopted the accounting standard update regarding revenue recognition for arrangements that include software elements. This update requires tangible products that contain software and non-software elements that work together to deliver the products' essential functionality to be evaluated under the accounting standard regarding multiple deliverable arrangements. We are currently evaluating the impact that this standard update will have in our financial statements.

2. PLANT, PROPERTY AND EQUIPMENT

The following table displays the details of Plant, property and equipment, which is stated at cost:

At December 31,	(dollars in millions)	
	2010	2009
Land	\$ 38	\$ 37
Buildings	813	821
Network equipment	11,977	12,662
Furniture, vehicles and other work equipment	209	221
Construction-in-progress	31	24
Other	57	81
	13,125	13,846
Less accumulated depreciation	8,814	9,410
Total	\$ 4,311	\$ 4,436

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3. LEASES

We lease certain facilities and equipment for use in our operations under both capital and operating leases. Total rent expense amounted to \$78 million in 2010 and \$90 million in 2009. Of these amounts, \$66 million in 2010 and \$72 million in 2009 were lease payments to affiliated companies.

The following table displays the aggregate minimum rental commitments under noncancelable operating leases for the periods shown at December 31, 2010, excluding those with affiliated companies:

Years	Operating Leases
2011	\$ 9
2012	8
2013	4
2014	---
2015	---
Thereafter	3
Total minimum rental commitments	\$ 24

4. DEBT

Debt Maturing Within One Year

Debt maturing within one year is as follows:

At December 31,	(dollars in millions)	
	2010	2009
Notes payable to affiliate VNFC	\$ ---	\$ 1,895
Total debt maturing within one year	\$ ---	\$ 1,895

Weighted average interest rate for note payable outstanding at year-end	---	0.73%
---	-----	-------

We have contractual agreements with affiliated companies, Verizon Network Funding Corp. (VNFC) and Verizon Investments Inc., for the provision of financing and cash management services.

Long-Term Debt

Outstanding long-term debt consists of the following:

At December 31,	Interest Rate	Maturity	(dollars in millions)	
			2010	2009
Twenty-nine year debenture	6.75%	2027	\$ 200	\$ 200
Five year debenture (Verizon Investments, Inc.)	4.65	2014	1,000	1,000
			1,200	1,200
Other (primarily capital lease obligations)			1	1
Total long-term debt, including current maturities			1,201	1,201
Less maturing within one year			---	---
Total long-term debt			\$ 1,201	\$ 1,201

During 2009, we entered into an internal 4.65% fixed rate, five year note with Verizon Investments Inc. for \$1.0 billion and the proceeds were used to pay down the \$225 million 5.50% and \$300 million 6.70% notes that matured.

The aggregate principal amount of bonds and debentures that may be issued is subject to the restrictions and provisions of our indentures. None of the securities shown above were held in sinking or other special funds or pledged by us. Debt discounts and premiums on our outstanding long-term debt are amortized over the lives of the respective issues.

We are in compliance with all of our debt covenants.

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Maturities of long-term debt outstanding at December 31, 2010, excluding unamortized discount and premium are as follows:

Years	(dollars in millions)
2011	\$ ---
2012	---
2013	---
2014	1,000
2015	---
Thereafter	200
Total long-term debt outstanding	\$ 1,200

The fair value of our debt, excluding capital leases, is determined based on market quotes for similar terms and maturities or future cash flows discounted at current rates. The fair value of our debt, excluding capital leases, was \$1,205 million and \$3,093 million at December 31, 2010 and 2009, respectively, as compared to the carrying value of \$1,199 million and \$3,094 million, respectively at December 31, 2010 and 2009.

5. EMPLOYEE BENEFITS

We participate in Verizon's benefit plans. Verizon maintains noncontributory defined benefit pension plans for many of our employees. The postretirement health care and life insurance plans for our retirees and their dependents are both contributory and noncontributory and include a limit on Verizon's share of cost for certain recent and future retirees. Verizon also sponsors defined contribution savings plans to provide opportunities for eligible employees to save for retirement on a tax-deferred basis. We use a measurement date of December 31 for our pension and postretirement health care and life insurance plans.

The structure of Verizon's benefit plans does not provide for the separate determination of certain disclosures for our company. The required information is provided on a consolidated basis in Verizon's Annual Report on Form 10-K for the year ended December 31, 2010.

Pension and Other Postretirement Benefits

Pension and other postretirement benefits for the majority of our employees are subject to collective bargaining agreements. Approximately 90% of our employees (associates) are covered by collective bargaining agreements. Modifications in benefits have been bargained from time to time, and Verizon may also periodically amend the benefits in the management plans.

Benefit Cost

The following table displays the details of net periodic pension and other postretirement costs:

Years Ended December 31,	(dollars in millions)			
	Pension		Health Care and Life	
	2010	2009	2010	2009
Net periodic benefit (income) cost	\$ (105)	\$ (123)	\$ 49	\$ 65
Termination benefits	---	2	---	1
Settlement loss	83	211	---	---
Curtailment loss	---	31	---	47
Subtotal	83	244	---	48
Total (income) cost	\$ (22)	\$ 121	\$ 49	\$ 113

In 2010, we recorded a pension settlement loss of \$83 million related to employees that received lump-sum distributions, primarily resulting from our previous separation plans, as prescribed payment thresholds were reached.

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In 2009, we recorded a pension settlement loss of \$211 million related to employees that received lump-sum distributions, primarily resulting from our previous separation plans, as prescribed payment thresholds were reached. Additionally, we recorded pension and postretirement curtailment losses of \$78 million as workforce reductions caused the elimination of a significant amount of future service requiring us to recognize a portion of the prior service cost and actuarial losses.

Amounts recognized in the balance sheets consist of:

At December 31,	(dollars in millions)			
	Pension		Health Care and Life	
	2010	2009	2010	2009
Prepaid pension asset	\$ 2,555	\$ 2,535	\$ ---	\$ ---
Employee benefit obligations	1	2	724	720

Changes in benefit obligations were caused by factors including changes in actuarial assumptions, settlements and curtailments.

Beginning in 2013, as a result of federal health care reform, Verizon will no longer file for the Retiree Drug Subsidy (RDS) and will instead contract with a Medicare Part D plan on a group basis to provide prescription drug benefits to Medicare eligible retirees. This change to our Medicare Part D strategy, resulted in the adoption of plan amendments during the fourth quarter of 2010, which will allow the company to be eligible for greater Medicare Part D plan subsidies over time.

Assumptions

The weighted-average assumptions used in determining benefit obligations follow:

At December 31,	Pension		Health Care and Life	
	2010	2009	2010	2009
Discount rate	5.75 %	6.25 %	5.75 %	6.25 %
Rate of compensation increases	3.00	4.00	N/A	N/A

The weighted-average assumptions used in determining net periodic cost follow:

At December 31,	Pension		Health Care and Life	
	2010	2009	2010	2009
Discount rate	6.25 %	6.75 %	6.25 %	6.75 %
Expected return on plan assets	8.50	8.50	8.25	8.25
Rate of compensation increases	4.00	4.00	N/A	N/A

In order to project the long-term target investment return for the total portfolio, estimates are prepared for the total return of each major asset class over the subsequent 10-year period, or longer. Those estimates are based on a combination of factors including the current market interest rates and valuation levels, consensus earnings expectations, historical long-term risk premiums and value-added. To determine the aggregate return for the pension trust, the projected return of each individual asset class is then weighted according to the allocation to that investment area in the trust's long-term asset allocation policy.

The assumed Health Care Cost Trend Rates follow:

At December 31,	Health Care and Life	
	2010	2009
Health care cost trend rate assumed for next year	7.75 %	8.00 %
Rate to which cost trend rate gradually declines	5.00	5.00
Year the rate reaches level it is assumed to remain thereafter	2016	2014

Verizon California Inc.

Savings Plans and Employee Stock Ownership Plans

Substantially all of our employees are eligible to participate in savings plans maintained by Verizon. Verizon maintains four leveraged employee stock ownership plans (ESOP). Under this plan, a certain percentage of eligible employee contributions are matched with shares of Verizon's common stock. We recognize savings plan cost based on our matching obligation attributable to our participating management employees. In addition to the ESOP, Verizon also maintains a savings plan for associate employees. We recorded total savings plan costs of \$14 million in 2010 and \$15 million in 2009.

Severance Benefits

The following table provides an analysis of our severance liability recorded in accordance with the accounting standard regarding employers' accounting for postemployment benefits:

	(dollars in millions)			
Year	Beginning of Year	Charged for Expenses (a)	Payments	End of Year (b)
2009	\$ 37	\$ 47	\$ (24)	\$ 60
2010	60	13	(23)	50

- (a) Includes accruals for ongoing employee severance costs and \$10 million of charges in 2010 and \$43 million in 2009 for the involuntary separation of employees.
- (b) The remaining severance liability includes future contractual payments to employees separated as of the end of the year.

6. INCOME TAXES

The components of the provision (benefit) for income taxes are presented in the following table:

	(dollars in millions)	
Years Ended December 31,	2010	2009
Current:		
Federal	\$ 76	\$ 83
State and local	47	67
Total	<u>123</u>	<u>150</u>
Deferred:		
Federal	211	85
State and local	18	(19)
Total	<u>229</u>	<u>66</u>
Total provision for income taxes	<u>\$ 352</u>	<u>\$ 216</u>

The following table shows the principal reasons for the difference between the effective income tax rate and the statutory federal income tax rate:

Years Ended December 31,	2010	2009
Statutory federal income tax rate	35.0 %	35.0 %
State income taxes, net of federal tax benefits	5.3	5.5
Medicare Part D subsidy charge	3.9	---
Other, net	(0.2)	(2.7)
Effective income tax rate	<u>44.0 %</u>	<u>37.8 %</u>

Verizon California Inc.

The change in the income tax benefit in 2010 was impacted by a one-time, non-cash income tax charge of \$31 million. Under the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010, both of which became law in March 2010 (collectively the Health Care Act), beginning in 2013, Verizon and other companies that receive a subsidy under Medicare Part D to provide retiree prescription drug coverage will no longer receive a federal income tax deduction for the expenses incurred in connection with providing the subsidized coverage to the extent of the subsidy received. Because future anticipated retiree prescription drug plan liabilities and related subsidies are already reflected in our financial statements, this change required us to reduce the value of the related tax benefits recognized in our financial statements in the period during which the Health Care Act was enacted.

Deferred taxes arise because of differences in the book and tax bases of certain assets and liabilities. Significant components of our deferred tax assets and liabilities are shown in the following table:

Years Ended December 31,	(dollars in millions)	
	2010	2009
Deferred tax assets:		
Employee benefits	\$ 18	\$ 15
Allowance for uncollectible accounts	6	8
Other - assets	39	30
Total deferred tax assets	63	53
Deferred tax liabilities:		
Employee benefits	716	673
Depreciation	855	686
Other - liabilities	19	1
Total deferred tax liabilities	1,590	1,360
Net deferred tax liability	\$ 1,527	\$ 1,307

Unrecognized Tax Benefits

A reconciliation of the beginning and ending balance of unrecognized tax benefits is as follows:

At December 31,	(dollars in millions)	
	2010	2009
Balance at January 1,	\$ 30	\$ 40
Additions based on tax positions related to the current year	8	3
Additions for tax positions of prior years	13	10
Reductions for tax positions of prior years	(7)	(23)
Balance at December 31,	\$ 44	\$ 30

Included in the total unrecognized tax benefits at December 31, 2010 and 2009 is \$5 million and \$5 million, respectively that, if recognized, would favorably affect the effective income tax rate.

We recognized the following net after tax (expense)/benefit related to interest and penalties in the provision for income taxes:

At December 31,	(dollars in millions)	
2010	\$	---
2009		6

Verizon California Inc.

The after tax accrual for the payment of interest and penalties in the balance sheet are as follows:

At December 31,	(dollars in millions)	
2010	\$	5
2009		5

Verizon and/or its domestic subsidiaries file income tax returns in the U.S. federal jurisdiction and various state and local jurisdictions. The Internal Revenue Service (IRS) is currently examining Verizon's U.S. income tax returns for years 2004 through 2006. As a large taxpayer, we are under continual audit by the IRS and multiple state jurisdictions on numerous open tax positions. It is reasonably possible that the amount of the remaining liability for unrecognized tax benefits could change by a significant amount during the next twelve-month period. An estimate of the range of the possible change cannot be made until issues are further developed or examinations close.

7. TRANSACTIONS WITH AFFILIATES

Our financial statements include transactions with the following affiliates:

At December 31,	(dollars in millions)	
	2010	2009
Operating revenues:		
Verizon Online	\$ 548	\$ 500
Verizon Business	135	144
Verizon Wireless Inc.	45	47
Verizon Long Distance	36	37
Verizon Operating Telephone Companies	7	12
Verizon Services	7	4
Other	1	1
	\$ 779	\$ 745
Operating expenses:		
Verizon Services	\$ 743	\$ 698
Verizon Data Services Inc.	103	100
Verizon Business	3	4
Verizon Wireless Inc.	2	1
	\$ 851	\$ 803
Interest expense:		
Interest expense to Verizon Network Funding Corp.	\$ 6	\$ 14
Interest expense to Verizon Investments, Inc.	47	33
	\$ 53	\$ 47
Equity infusion from GTE Corporation	\$ 1,300	\$ ---
Dividends paid to GTE Corporation	\$ ---	\$ 1,187

Outstanding balances with affiliates are reported on the balance sheets at December 31, 2010 and 2009 as Notes receivable from affiliates, Accounts receivable - affiliates, Notes payable - affiliates, and Accounts payable and accrued liabilities - affiliates.

Verizon California Inc.

Verizon Online

Our operating revenues include transactions with Verizon Online LLC (Verizon Online) associated with the provision of network access and billing and collection services. These revenues are earned from Verizon Online, which utilizes our facilities to provide Internet access services to their customers. Revenues from Verizon Online include revenues from GTE.net LLC, which merged with and into Verizon Online on March 31, 2009.

Verizon Business

Our operating revenues include transactions with Verizon Business associated with the provision of network access services, wholesale interconnection service agreements and from billing and collection services.

Our operating expenses also include transactions with Verizon Business. We recognize costs associated with interconnection agreements and capacity services agreements.

Verizon Wireless Inc.

Our operating revenues include transactions with Verizon Wireless Inc. (Verizon Wireless) associated with the provision of local and network access services, billing and collection services and from interconnection agreements. These revenues are earned from Verizon Wireless who provides wireless voice and data services, paging services and equipment sales to their customers.

Our operating expenses also include transactions with Verizon Wireless. We recognize costs associated with wireless voice and data services, paging services and for interconnection agreements.

Verizon Long Distance

Our operating revenues include transactions with Verizon Long Distance associated with the provision of local and network access and billing and collection services. These revenues are earned from Verizon Long Distance who utilizes our facilities to provide long distance services to their customers.

Verizon Operating Telephone Companies

Our operating revenues include transactions with other Verizon Operating Telephone Companies. Revenues associated with transactions with these affiliates are primarily earned from the rental of our facilities and equipment.

Verizon Services

Our operating revenues and expenses include transactions with Verizon Services (including Verizon Services Corp., Verizon Services Group and Verizon Corporate Services Group Inc.), for the provision of local telephone service.

We have contractual arrangements with Verizon Services (including Verizon Services Corp., Verizon Services Group, and Verizon Corporate Services Group Inc.) for the provision of various centralized services. These services are divided into two broad categories. The first category is comprised of network related services which generally benefit only Verizon's operating telephone subsidiaries. These services include marketing, sales, legal, accounting, finance, data processing, materials management, procurement, labor relations, and staff support for various network operations. The second category is comprised of overhead and support services which generally benefit all subsidiaries of Verizon. Such services include corporate governance, corporate finance, external affairs, legal, media relations, employee communications, corporate advertising, human resources, treasury, and rent expenses associated with the rental of facilities and equipment. Costs may be either directly assigned to one subsidiary or allocated to more than one subsidiary based on functional reviews of the work performed.

Verizon California Inc.

Verizon Data Services Inc.

Verizon Data Services Inc. provides data processing services, software application development and maintenance, which generally benefits Verizon's operating telephone subsidiaries, including us. We are charged for these affiliated transactions based on proportional cost allocation methodologies.

Other Affiliates

Other operating revenues include miscellaneous items of income resulting from transactions with other affiliates. These transactions include the provision of local and network access services, rental of facilities and equipment.

Verizon Network Funding Corp. and Verizon Investments, Inc.

We recognize interest expense in connection with a contractual agreement with an affiliated company, (VNFC and Verizon Investments) for the provision of short-term financing, short-term investing and cash management services.

8. ADDITIONAL FINANCIAL INFORMATION

The tables below provide additional financial information related to our financial statements:

	(dollars in millions)	
Years Ended December 31,	2010	2009
Cash Flow Information:		
Cash paid during the year for:		
Income taxes paid, net	\$ 47	\$ 186
Interest, net of amounts capitalized (excluding affiliates)	13	39
Income Statement Information:		
Depreciation expense	493	518
Interest costs incurred	67	75
Capitalized interest	(1)	(1)
Advertising expense (allocated to us by Verizon Services)	46	28

9. COMMITMENTS AND CONTINGENCIES

Various legal actions and regulatory proceedings are pending to which we are a party and claims which, if asserted, may lead to other legal actions. We have established reserves for specific liabilities in connection with regulatory and legal matters that we currently deem to be probable and estimable. We do not expect that the ultimate resolution of pending regulatory and legal matters in future periods will have a material effect on our financial condition, but it could have a material effect on our results of operations.

From time to time, state regulatory decisions require us to assure customers that we will provide a level of service performance that falls within prescribed parameters. There are penalties associated with failing to meet those service parameters and we, from time to time, pay such penalties. We do not expect these penalties to have a material effect on our financial condition, but they could have a material effect on our results of operations.