VZ - Verizon Communications Inc to Discuss FCC Spectrum Auction Results

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OVERVIEW:
VZ provided an update on spectrum auction.
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PRESENTATION

Operator

Good morning and welcome to the Verizon investor conference call to discuss the results of the FCC's spectrum auction. (Operator Instructions) Today's conference is being recorded. If you have any objections you may disconnect at this time.

It is now my pleasure to turn the call over to your host, Mr. Michael Stefanski, Senior Vice President, Investor Relations.

Michael Stefanski  Verizon Communications Inc. - SVP IR

Thanks, David. Good morning and thank you for joining us today. This is Mike Stefanski, and I'm here with Fran Shammo, our Chief Financial Officer, and Tony Melone, our Executive Vice President of Network.

As you know, Auction 97 ended on January 29. We have had to wait until the anti-collusion quiet period ended last Friday at 6:00 PM before we could comment on the spectrum we acquired and discuss our network and spectrum strategy.

Before we get started I will point out that presentation slides for this call are available on our Investor Relations website. Replays and a transcript of this call will also be made available on our website.

I would also like to draw your attention to our Safe Harbor statement on slide 2. Information in this presentation contains statements about expected future events and financial results that are forward-looking and subject to risks and uncertainties. Discussion of factors that may affect future results is contained in Verizon's filings with the SEC, which are available on our website.

With that I will now turn the call over to Fran.

Fran Shammo  Verizon Communications Inc. - EVP, CFO

Thank you, Mike. Good morning, everyone, and thank you for joining us. We are off to a busy start in 2015.
On January 22 we covered our fourth-quarter earnings results and 2015 outlook. On February 5, we discussed the transactions to monetize our towers, sell Wireline properties, and execute an accelerated share buyback program while remaining committed to our deleveraging plan. Today, we will discuss our commitment to extend our network leadership by strategically increasing network capacity in a financially disciplined manner.

I will start the discussion by reviewing the strategic context of our participation in the auction and then quickly review our funding plan. I will then turn it over to Tony to take you to the details of the spectrum we acquired and our network strategy, before we take your questions.

The foundation of our success is the competitive advantage provided by the depth and breadth of our networks. Acquiring more AWS spectrum is consistent with our strategy to leverage our 4G LTE network as a platform for innovation and future growth.

We are pleased with the licenses we acquired, and we improved our spectrum depth in the markets that we wanted. We won 181 licenses in markets covering 192 million POPs for a total of $10.4 billion.

Our bidding strategy was straightforward, and the results of the auction enable us to efficiently execute on our network strategy. Tony will provide more detail about our market-based bidding strategy that we executed on while maintaining good financial discipline between spectrum acquisition and capital investments to increase capacity.

With the transactions we announced earlier this month and acquisition of this spectrum, our balance sheet remains strong, and we continue to have the financial flexibility to grow the business and pursue our strategic goals.

Next, let me briefly review the funding plan which I explained when we announced the monetization transactions. We had a balance of $9.5 billion to pay for the spectrum purchase, net of the $900 million deposit. We ended 2014 with $10.6 billion of cash on hand, a significant portion of which is available for investing and return of value.

We funded the ASR and paid for 20% of the spectrum with cash on hand. We will fund the remaining balance with a $6.5 billion term loan. When we receive the tower proceeds in the next few months, we will pay down the majority of the term loan.

The proceeds from the Frontier transaction, which we expect to receive in the first half of 2016, will be utilized to pay off debt maturing in the second half of 2016, which is part of our deleveraging plan. As I have consistently said, our objective is to get back to our pre-Vodafone transaction credit rating profile in the 2018 to 2019 time frame.

I will stop here and ask Tony to talk more about our auction and network strategy.

Tony Melone - Verizon Communications Inc. - EVP, Network

Thanks, Fran, and good morning, everyone. As Fran stated, our fundamental network strategy of consistently delivering industry-leading reliability, performance, and efficiency has been grounded in two key principles: first, an aggressive investment in technology; and second, securing the necessary radio spectrum to complement that technology.

Our success in executing on this strategy is reaffirmed quarter after quarter and year after year. We continue to believe that great network performance, combined with an industry-leading cost structure, will serve our customers and shareholders well, irrespective of the particular industry dynamics that tend to change on a quarterly basis. This consistency of approach has been a key competitive advantage for Verizon over the last decade and a half.

Before I discuss the specifics of Auction 97, I thought it would be helpful to give you some context of how we think about this combination of technology and spectrum with respect to our network strategy. Think of our wireless network as a factory that produces bits; specifically, bits over the air. The production of these bits requires the two basic elements of technology and spectrum.
Technology in this case means the combination of radio access technology, which is LTE in our case, along with a corresponding network topology of small cells, distributed antenna systems, and specialized in-building systems. The simplistic equation on the slide is an effective way to show the essential nature of each.

One without the other is useless. Effectively, there is a practical minimum required of each. Once that practical minimum is achieved, the decision to favor one versus the other is entirely based on cost and, of course, availability.

Entering the auction, there were no markets where we felt compelled to acquire additional spectrum irrespective of the price.

Now, with that said, spectrum has historically been an extremely cost effective means of adding capacity. And despite the fact that costs associated with technology solutions have continued to go down year after year while spectrum costs were rising, and we certainly expected that they would rise considerably in this auction, we still felt that additional AWS spectrum would be extremely valuable and cost-effective.

Therefore, we entered Auction 97 with a desire to acquire additional spectrum in most markets. We had a defined bidding strategy that contemplated multiple scenarios.

Now, as the auction evolved, the particular scenarios that leveraged the technology side of the equation came more into play. The key reason why we had this flexibility in strategy is the fact that we had a very strong spectrum position going into the auction.

Now, much is made of the quantity of spectrum that each carrier holds, but spectrum strategy is much more than simply acquiring megahertz. Equally, if not more important, is what bands we have; are they fairly ubiquitous across the footprint; are they mainstream industry bands; and are they free from encumbrances?

Our success in acquiring a nationwide footprint of 700C spectrum to serve as the foundation of our LTE network was and continues to be a key strategic win for Verizon. In addition, acquiring substantial AWS-1 spectrum through auction and secondary market transaction over the years has positioned us very well. Of course, all at a reasonable price per megahertz POP.

Prior to the auction we had a very strong mix of coverage and capacity spectrum, with average nationwide holdings of 105 megahertz. However, there were disparities among markets. For example, New York City we had 127 megahertz, while in LA and San Francisco we had 107, and we held 97 megahertz in places like Philadelphia, San Diego, and Chicago.

As I mentioned, having the benefit of 20 megahertz of 700C spectrum for our national 4G LTE coverage layer allows us to focus on AWS and PCS spectrum exclusively for our capacity needs. While most of our 47 megahertz of 850 and PCS spectrum is being used today for our CDMA voice and 3G data services, the aggressive shift of data traffic to 4G over the last few years has allowed us to re-farm PCS in 2014. Eventually, 850 megahertz will also be transitioned to LTE, most likely as a 5-by-5 block initially. Keep in mind that LTE advanced capabilities, including carrier aggregation, give us tremendous flexibility in leveraging our spectrum assets in a very efficient manner.

Now that you have a good understanding of our current spectrum portfolio, let’s turn to the next slide to discuss our auction strategy and how the licenses that we won enhance our spectrum portfolio. As you can see from the slide, our pre-auction AWS-1 holdings were principally skewed towards the eastern part of the United States. Given that AWS-1 and AWS-3 bands will be one common band, our objective was to acquire enough AWS-3 spectrum to give us a minimum 40 megahertz total AWS in most markets.

We also wanted to opportunistically achieve contiguity between existing AWS-1 F block and AWS-3 G block where appropriate. This strategy would, by default, also drive our mid-band spectrum position to over 60 megahertz in most markets.

The next slide gives you a clear picture of why we are pleased with our auction results. With few exceptions, we have met our objectives while also maintaining sound financial discipline.
We have significantly improved our AWS spectrum position, now having 40 megahertz or more in 92 of the top 100 markets. We won the markets we felt were most critical, including LA, San Diego, Baltimore, and San Francisco, while forgoing markets such as New York and Boston, where we had a very strong position going in.

Please refer to the next slide to see a summary of licenses won across the top-25, top-50 and top-100 markets. While the dollars spent are skewed toward the top 25, the licenses acquired were fairly balanced across the top 100 when viewed on a megahertz-per-POP basis -- again, reflecting our intent to acquire spectrum in the markets with less AWS depth.

As a result of Auction 97, our total spectrum holdings have now increased to 116 megahertz, with AWS holdings averaging 48 megahertz nationwide. And, as I mentioned, the 116 megahertz is far more balanced nationally. With the addition of the licenses won at this auction we have spectrum holdings that allow us to cost-effectively meet the anticipated growth needs of the business in the near term.

Let's turn to slide 13 to see how we intend to continue to execute on our industry-leading network performance and cost position in the future. As I showed on an earlier slide, technology is driving both operating expense and capital expenditure cost curves in the right direction. As a result, small cell deployments will be an increasingly cost-effective way to add capacity while at the same time improving cell edge performance and, thus, further increasing the value of the spectrum we currently hold.

A healthy competitive market has emerged for fiber providers over the past several years that give us great confidence in our ability to execute on our small cell plan. In addition, distributed antenna system providers are continuing to expand their already excellent relationships with municipalities and, as such, have become trusted partners in executing our capacity plan.

For the few particular markets where we would have started leveraging AWS-3 in 2017 but did not purchase the spectrum in the auction, we will be increasing our investment in capacity solutions in each of the next three years.

In addition, we will continue to be on the leading edge of technology advancements: leveraging the annual improvements expected of LTE, enhanced antenna technologies, and interference management techniques. All of these technology solutions will drive improvements in bits per hertz and cost per bit.

While we have consistently avoided building our own Wi-Fi networks outside of unique venues such as stadiums, we have always viewed Wi-Fi as complementary to our managed network. As such, we are very optimistic about LTE over unlicensed spectrum as a future capacity solution. With our key suppliers we are active in the standards process and will likely deploy a pre-standard version in the not-too-distant future.

Of course, we will continue to look at the secondary market for specific cost-effective opportunities to augment our strong spectrum position. And finally, as more spectrum comes to auction including the incentive auction targeted for 2016, we will carefully look at the rules and evaluate if, and, or how our participation would enhance achievement of our network strategy.

With that, I'm going to hand it back to Fran.

Fran Shammo - Verizon Communications Inc. - EVP, CFO

Thanks, Tony. So as you can see, we have a long-term network strategy that included our defined plan for Auction 97, and we executed. Our disciplined approach enabled us to win the licenses and the markets we wanted. I am very pleased with the outcome of the auction and the transactions to optimize our assets.

As Tony described, we have the spectrum to meet the growth needs of our business, and our future plans do not require us to acquire large blocks of spectrum in the near term. As always, we will evaluate the secondary market to fill in our spectrum portfolio.

Our balance sheet remains strong to allow us to invest in new products and services for future growth and profitability outside of spectrum. Our 2015 capital outlook of $17.5 billion to $18 billion includes an incremental $500 million for our network densification efforts in certain markets.
Our funding plan keeps us on track to getting back to our pre-Vodafone transaction credit rating in the 2018 to 2019 time frame. And our use of proceeds from the recently announced transactions also effectively returns value to our shareholders.

Again, our 2014 operating and financial performance shows that we have the ability to compete effectively in any market environment. And we will continue to look at all aspects of our cost structure and investments to drive earnings growth and return on invested capital.

With that I will turn the call back to Mike so we can get to your questions.

Michael Stefanski - Verizon Communications Inc. - SVP IR
Thank you, Fran. David, we're now ready to take questions.

QUESTIONS AND ANSWERS

Operator
(Operator Instructions) Simon Flannery, Morgan Stanley.

Simon Flannery - Morgan Stanley - Analyst
Thank you very much and good morning. And thanks for holding the call; very helpful. Fran, you just talked about the CapEx for this year. Is it fair to consider, given the assets you have now, that this is a good run rate, maybe as a percent of revenues, over the next two to three years, as you consider the spectrum you have and the assets?

Then Tony, you talked about CDMA re-farming a little bit. Can you just drill down a bit more on that and talk about the timing for maybe freeing up a 5-by-5 there? And when can you think about ultimately taking out CDMA altogether? Thank you.

Fran Shammo - Verizon Communications Inc. - EVP, CFO
Thanks, Simon. On the CapEx, yes; as we gave guidance back at the end of the fourth-quarter call, the $17.5 billion to $18 billion was in anticipation of the $500 million that Tony talked about over the next three years. So to answer your question, Simon: yes.

As we've said before and I've said before, you should consider us a flat CapEx Company. I don't see CapEx going down because of the wireless continuing to increase, with an offset in the Wireline business. But as far as a CapEx to revenue ratio goes, you should continue to see improvement in that trending out over time; so that's where we stand. So, Tony?

Tony Melone - Verizon Communications Inc. - EVP, Network
Thanks. Yes, thanks, Fran; Simon, thank you. In terms of re-farming, our plan is to start with PCS spectrum. As I mentioned, we've already cleared PCS spectrum and are deploying it for LTE in several markets in 2014; we plan to do more of that in 2015; and over the next several years we will do a considerable amount of LTE over PCS.

Relying on 850 will probably come post-PCS with few exceptions. There are certain markets where we have 50 megahertz of 850 spectrum; in that case, we will utilize 850 sooner.
But ultimately, CDMA will reside on 850-megahertz spectrum exclusively. At that point in time we will have limited usage on that network, so we will be able to take 5-by-5 of 850 and ultimately deploy the last 5-by-5 when we shut down CDMA.

Currently, we have contractual obligations with certain large customers that keep that in play into the early 2020s.

Simon Flannery - Morgan Stanley - Analyst

Great. Thank you.

Operator

John Hodulik, UBS.

John Hodulik - UBS - Analyst

Okay, thanks. Thanks, guys, for holding the call; and Tony, great to have you on the call. I get asked a lot about really two things since the auctions. First of all, the attractiveness of leasing spectrum versus owning spectrum; and would you guys, as you look out a couple years, be interested in leasing spectrum from a third-party to fill some of the gaps?

And then the attractiveness of 2.5. I think you guys expressed some interest in potentially buying 2.5 a couple of years ago. I don't think it really went anywhere, but is that still something that could potentially fit into the network at some point? Thanks.

Fran Shammo - Verizon Communications Inc. - EVP, CFO

Thanks, John. In terms of owning versus leasing, the real issue when it comes to spectrum is being comfortable that we have control for the long term. So given the right structure and the right economics I don't think we would be averse to leasing again. It would need to be a long-term type of leasing structure. So that answers that question.

In terms of the 2.5 spectrum, again back to what I said earlier on spectrum strategy, provided the spectrum is a fairly common industry band and we have significant enough spectrum where we can deploy it fairly ubiquitous, it's certainly a spectrum that we would consider.

John Hodulik - UBS - Analyst

Got you. You guys have in the past said you have enough spectrum to -- I think before the auctions you already said through 2018. Given all the options you have from a technology standpoint, is there an updated date at which you don't think that you would need additional spectrum at this point?

Fran Shammo - Verizon Communications Inc. - EVP, CFO

John, that's a tricky question to answer -- maybe not tricky. In terms of what I talked about, the balance between technology solutions and spectrum, it really depends on what the economics are dictating on each side.

The key here is planning and forecasting and anticipating what our needs are. To the extent -- at this point in time we understand what the current pricing is of spectrum, so as a result of that we are planning capacity solutions and technology that give us what we need going forward.
If those dynamics change, we would certainly consider spectrum alternatives. But at this point in time I would say there is no definitive date when we need additional spectrum. We will just balance the two parts of the equation.

John Hodulik - UBS - Analyst
Okay, great. Thanks, guys.

Operator
Michael Rollins, Citi.

Michael Rollins - Citigroup - Analyst
Hi, good morning. Thanks for taking my questions. Two if I could.

The first is, I was wondering if you can discuss the margin implication of increasing cell density and using small cells to address capacity, especially in some of the markets where you didn't get additional spectrum.

Then the second question is, Tony, you described improving uniformity of spectrum across the country. I was wondering if you could talk about, because of that, are you now seeing a wider dispersion in spectrum per customer? For example, do you compare the spectrum per customer in a city like New York or Chicago maybe versus some of the other cities where you did get additional spectrum resources? Thanks.

Fran Shammo - Verizon Communications Inc. - EVP, CFO
Michael, I'll take the margin question here. Look, if you look at it, we have a fairly large CapEx program every year. This increases it by $500 million. Obviously, that would be low -- the amortization of that would be below the EBITDA line. But there is some dark fiber, of course, and fiber connections to the small cells that generally does increase OpEx expense.

But overall, this is not going to be material to the Wireless financials, so I would not anticipate any type of margin impact by making a decision of technology versus spectrum.

Tony Melone - Verizon Communications Inc. - EVP, Network
Michael, with regard to spectrum per customer, I think the more appropriate metric is spectrum per customer per cell. So as you densify in markets like Chicago, New York, etc., there's more cells; and therefore every cell you put it just doubles, triples, etc., multiplies the value of that spectrum and the ability to put that spectrum in play. So I think spectrum per customer in and of itself is not the correct way to look at it.

Michael Rollins - Citigroup - Analyst
Thanks very much.

Operator
Brett Feldman, Goldman Sachs.
Yes, thanks for taking the question. Tony, you were talking about the deployment of LTE advanced. I was hoping you could maybe give us a little more detail on what your roadmap is there.

For example, what's the timeline for deploying that? To what extent is it a network investment versus a handset investment? And then what are going to be the principal benefits that you achieve as result of getting that fully deployed through the network?

Hey, Brett; thank you. We are currently -- it's both a network and a handset evolution for many of the features. Some are principally network; some are principally device; but in general you can think of both.

And you should think about it as an incremental advancement. The benefits typically come into play as increasing capacity for the same amount of spectrum. A lot of that is driven by the interference management techniques that come.

In terms of things like carrier aggregation, the principal benefit there is to be able to get higher speeds, instantaneous speeds, for the same amount of spectrum that may otherwise have been split and fragmented. In terms of a capacity uplift, carrier aggregation doesn't give you that much of a lift. So it's more of instantaneous speed.

Could you just give us an example of how you specifically deploy your carrier aggregation, what it does for you? Just to help us visualize this a bit.

Yes. Again, though this will evolve over time, but currently carrier aggregation can only support 20 megahertz -- 20-by-20 megahertz. Eventually it will be 40-by-40, 60-by-60. So there is a roadmap over time in the technology.

So to the extent you have, like we do in New York, AWS spectrum that's 20-by-20 contiguous, carrier aggregation provides us no value, no benefit. Now, to the extent we had 10 megahertz of AWS and 10 megahertz of 700, aggregating those two would allow you to effectively have a 20-megahertz channel, which you can burst speeds higher than you would if you had two separate 10s.

Great. That was helpful. Thanks.

Kevin Smithen, Macquarie.

Thanks, Tony. I wondered if you could elaborate a little bit on the small cell economics. You mentioned that would drive down OpEx per megabit.
What do you -- just to give an example, how many small cells and DAS nodes would be needed for a major metro market? And what exactly are you getting -- how many sites will you roll out for $500 million a year for three years? What does this look like at the end of the three years?

Tony Melone - Verizon Communications Inc. - EVP, Network

Kevin, I'm not going to answer the specifics in terms of how many cells we are planning to deploy, because our overall build plan and capacity plan has many different factors and many different solutions available. What I can tell you is that in places like Boston we currently have a plan to put a 400-node DAS in play over -- started in 2014. So significant, highly dense solutions are already in play.

And again as I mentioned, the fiber providers and the work they've done with municipalities gives us tremendous amount of latitude to deploy many nodes as needed. And again, small cells are not the only solution; they are part of the solution.

Macrocells are still a major component in building systems. They're still a major component as well.

Kevin Smithen - Macquarie Research - Analyst

Just as a follow-up, obviously you've announced the tower transaction. How do you think about some of the flexibility in terms that you got on that deal with American Tower, as you continue to roll out macrocell sites and perhaps add additional equipment on your existing sites?

Tony Melone - Verizon Communications Inc. - EVP, Network

Kevin, we feel very good about having everything we need built into that agreement to allow us to implement our plans for the foreseeable future.

Kevin Smithen - Macquarie Research - Analyst

So you wouldn't expect any additional cost for several years?

Tony Melone - Verizon Communications Inc. - EVP, Network

Yes. Several years and more.

Operator

Frank Louthan, Raymond James.

Frank Louthan - Raymond James - Analyst

Great. Thank you. What applications do you see the unlicensed spectrum being used for?

And then to what extent would any major content deals that you might strike with content providers shift your roadmap for spectrum as you've laid it out here today?

Tony Melone - Verizon Communications Inc. - EVP, Network

Frank, let me take the first one in terms of LTE unlicensed. You should think about that utilized in a supplemental downlink opportunity.
Again, with small cells, utilizing unlicensed spectrum for LTE will be very similar to Wi-Fi in terms of power requirements, etc. So the advantage we will have is we will have centralized control and knowledge of the interference conditions, so we'll be able to bring that unlicensed spectrum into play when it's available, when it can provide a good experience for our customers. And again, use it as a supplemental downlink to augment capacity.

With respect to content deals, Frank, I can't comment on what I might see and speculate what might happen that might change our outlook on spectrum requirements, etc.

Frank Louthan - Raymond James - Analyst
All right, great. Thank you.

Michael Stefanski - Verizon Communications Inc. - SVP IR
All right, David. We have time for one more question.

Operator

Amir Rozwadowski, Barclays.

Amir Rozwadowski - Barclays Capital - Analyst
Thank you very much and good morning, folks. From my end, Tony, I was wondering if you could talk a bit about what's changed with respect to small cell architectures that gets you incrementally comfortable around the ability to deliver densification initiatives? I know there's been a lot of talk about small cells recently; though in the past you folks perhaps weren't as excited about the type of technology and densification solutions that could be provided by the technology. So we would love to hear your thoughts around that.

Tony Melone - Verizon Communications Inc. - EVP, Network
Amir, principally a couple things. First of all, municipalities have generally become much more receptive to the technology. In fact, places like Chicago, the folks planning their infrastructure are coming to us to work with us in terms of how we can effectively match our needs with what they are trying to accomplish, etc. So the receptivity is one thing that's improved.

Secondly, the technology itself, the cost of some of the equipment and the capacity that you get out of the small cell, has significantly increased. Interference management techniques, which are also an important part of having a highly dense network of cells, has improved.

And then just the proliferation of fiber, the competitiveness of that environment, the cost points associated with that, all these things combined are a big part of that. And then, finally, the cost of new spectrum: certainly at a time where spectrum was at a certain price per megahertz POP, that was a very effective solution. As those prices increase, small cell technology, with the improvements there, just the balance of the comparison between the two changed dramatically.

Amir Rozwadowski - Barclays Capital - Analyst
That's very helpful. Then just a quick follow-up. It does sound like the $500 million in CapEx is incremental investment. Just to clarify this, it doesn't seem as though you are really shifting away from investing on the macro side. This seems to be augmenting your network. Is that the appropriate way to think about things?
Tony Melone - Verizon Communications Inc. - EVP, Network

Yes, it is. Again, as I talked about the equation, we've always had the ability to drive capacity via the spectrum and technology. So the key here is, now we know what spectrum is available to us going forward, so we simply have to now adjust our plans in certain places where we may have anticipated having spectrum in 2017.

Fran Shammo - Verizon Communications Inc. - EVP, CFO

Yes, this is Fran. I think the other thing, too, is to keep in focus that, although you invest in spectrum, it also costs money and future resources to deploy that spectrum where you need to deploy it. So you also have to think about there is a cost of deploying spectrum.

Once you buy it doesn't mean that it goes up for free and there is no work behind that to deploy. So there is an offset here by building capacity versus deploying additional spectrum.

Amir Rozwadowski - Barclays Capital - Analyst

Thank you for the incremental color.

Michael Stefanski - Verizon Communications Inc. - SVP IR

David, that's all the time we have for questions today. But before we end I'd like to turn the call back to Fran to wrap us up.

Fran Shammo - Verizon Communications Inc. - EVP, CFO

All right. Thanks, Mike. Just a couple things. As you heard, we are very confident in our network strategy and funding approach. We will continue to execute on our overall strategy based on network strength, customer experience, and financial discipline.

These recent events continue to position us as the industry leader for 2015 and beyond, while staying on track with our deleveraging plan and returning value to our shareholders. Once again, thank you for joining us this morning; and we look forward to meeting again at our first-quarter earnings call.

Operator

Ladies and gentlemen, this does include the conference call for today. Thank you for your participation and for using Verizon conference services. You may now disconnect.