Verizon New England Inc.

Consolidated Financial Statements
As of December 31, 2008 and 2007
and for the years then ended

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REPORT OF INDEPENDENT AUDITORS

To The Board of Directors and Shareowner of Verizon New England Inc.

We have audited the accompanying consolidated balance sheets of Verizon New England Inc. ("the Company"), a subsidiary of Verizon Communications Inc., as of December 31, 2008 and 2007, and the related consolidated statements of operations, 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 consolidated financial position of Verizon New England Inc. at December 31, 2008 and 2007, and the consolidated results of its operations and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1 to the consolidated financial statements, the Company changed its method of accounting for uncertainty in income taxes effective January 1, 2007.

Ernst + Young LLP

New York, New York
March 27, 2009

CONSOLIDATED STATEMENTS OF OPERATIONS

Years Ended December 31,	2008	2007
		(dollars in millions)
Operating Revenues	**$ 2,853**	$ 3,772
Operating Expenses		
Cost of services and sales (exclusive of items shown below)	**1,443**	1,708
Selling, general and administrative expense	**688**	993
Depreciation and amortization expense	**657**	866
Total Operating Expenses	**2,788**	3,567
Operating Income	**65**	205
Other income (expense), net	**27**	25
Interest expense	**(117)**	(172)
Income Before Provision for Income Taxes	**(25)**	58
Income tax benefit (provision)	**23**	(18)
Net Income (Loss)	**$ (2)**	$ 40

See Notes to Consolidated Financial Statements.

CONSOLIDATED BALANCE SHEETS

ASSETS

At December 31,	2008	2007
		(dollars in millions)
Current assets		
Short-term investments	**$ 22**	$ 170
Notes receivable from affiliate	**44**	125
Accounts receivable:		
Trade and other, net of allowances for uncollectibles of $79 and $93	**425**	585
Affiliates	**318**	85
Materials and supplies	**40**	21
Prepaid expenses	**3**	3
Deferred income taxes	**81**	28
Deferred charges and other	**121**	80
Total current assets	**1,054**	1,097
Plant, property and equipment	**13,579**	18,726
Less accumulated depreciation	**9,143**	12,615
	4,436	6,111
Intangible assets, net	**11**	9
Prepaid pension asset	**161**	168
Other assets	**230**	236
Total assets	**$ 5,892**	$ 7,621

See Notes to Consolidated Financial Statements.

CONSOLIDATED BALANCE SHEETS

LIABILITIES AND SHAREOWNER'S INVESTMENT

At December 31,	2008	(dollars in millions) 2007
Current liabilities		
Debt maturing within one year:		
Notes payable to affiliate	**$ 220**	$ 169
Other	**201**	2
Accounts payable and accrued liabilities:		
Affiliates	**484**	524
Other	**258**	255
Other current liabilities	**212**	224
Total current liabilities	**1,375**	1,174
Long-term debt		
Notes payable to affiliate	**125**	825
Other	**1,704**	1,887
Employee benefit obligations	**1,888**	1,898
Deferred credits and other liabilities		
Deferred income taxes	**55**	304
Unamortized investment tax credits	**9**	15
Other	**163**	145
	227	464
Shareowner's investment		
Common stock – one share, without par value	**1**	1
Contributed capital	**424**	1,222
Reinvested earnings	**148**	150
Total shareowner's investment	**573**	1,373
Total liabilities and shareowner's investment	**$ 5,892**	$ 7,621

See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREOWNER'S INVESTMENT

Years Ended December 31,	2008	2007
	(dollars in millions)	
Common Stock		
Balance at beginning of year	**$ 1**	$ 1
Balance at end of year	**1**	1
Contributed Capital		
Balance at beginning of year	**1,222**	1,222
Equity adjustments related to the Fairpoint transaction	**362**	---
Return of capital to parent	**(1,160)**	---
Balance at end of year	**424**	1,222
Reinvested Earnings		
Balance at beginning of year	**150**	166
Adoption of FIN 48	**---**	(6)
Adjusted balance at beginning of year	**150**	160
Net income (loss)	**(2)**	40
Dividends declared	**---**	(50)
Balance at end of year	**148**	150
Total Shareowner's Investment	**$ 573**	$ 1,373

See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years Ended December 31,	2008	2007
	(dollars in millions)	
Cash Provided by Operating Activities		
Net income (loss)	**$ (2)**	$ 40
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	**657**	866
Deferred income taxes, net	**(52)**	(175)
Employee retirement benefits	**267**	328
Provision for uncollectible accounts	**28**	40
Equity income from affiliates	**(17)**	(14)
Dividends received from equity affiliates	**19**	12
Changes in current assets and liabilities:		
Accounts receivable	**(255)**	(6)
Other current assets	**11**	33
Accounts payable and accrued liabilities	**96**	(54)
Other current liabilities	**25**	(10)
Other, net	**(367)**	(73)
Net cash provided by operating activities	**410**	987
Cash Flows from Investing Activities		
Capital expenditures (including capitalized network and non-network software)	**(635)**	(834)
Purchases of short-term investments	**(23)**	(169)
Proceeds from sale of short-term investments	**170**	214
Change in note receivable from affiliate	**81**	(125)
Other, net	**108**	18
Net cash used in investing activities	**(299)**	(896)
Cash Flows from Financing Activities		
Proceeds from borrowings from affiliates	**125**	605
Early extinguishment of debt	**---**	(480)
Principal repayments of borrowings and capital lease obligations	**(825)**	(127)
Net change in current notes payable to affiliates	**1,407**	(37)
Dividends paid	---	(50)
Capital contribution from parent	**344**	---
Return of capital to parent	**(1,160)**	---
Other, net	**(2)**	(2)
Net cash used in financing activities	**(111)**	(91)
Net change in cash	**---**	---
Cash, beginning of year	**---**	---
Cash, end of year	**$ ---**	$ ---

See Notes to Consolidated Financial Statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

Verizon New England Inc. (Verizon New England or the Company) and its wholly owned subsidiary, Northern New England Telephone Operations, LLC, are wholly owned subsidiaries of NYNEX Corporation (NYNEX), which is a wholly owned subsidiary of Verizon Communications Inc. (Verizon). In 2007 and the first quarter of 2008, we served a territory consisting of Local Access and Transport Areas (LATA) in Maine, Massachusetts, New Hampshire, Rhode Island and Vermont. We have one reportable segment which provides domestic wireline telecommunications services. We currently provide two 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.

The communications services we provide are subject to regulation by the state regulatory commissions of Maine, Massachusetts, New Hampshire, Rhode Island and Vermont with respect to intrastate rates and services and other matters. The Federal Communications Commission (FCC) regulates rates that we charge long distance carriers and end-user subscribers for interstate access services.

On April 16, 2001, February 22, 2002, April 17, 2002, June 19, 2002, and September 25, 2002, the FCC released orders approving our applications for permission to enter the in-region long distance markets in Massachusetts, Rhode Island, Vermont, Maine and New Hampshire, respectively. The United States Court of Appeals for the District of Columbia has remanded the Massachusetts order to the FCC for further explanation on one issue, but left our long distance authority in effect. Since April 26, 2001, March 7, 2002, April 30, 2002, July 1, 2002 and October 23, 2002 in-region long distance service is being offered in Massachusetts, Rhode Island, Vermont, Maine and New Hampshire, respectively, by a separate non-regulated subsidiary of Verizon as required by law.

On January 16, 2007, Verizon announced a definitive agreement with FairPoint Communications, Inc. (FairPoint) providing for Verizon to establish a separate entity for its local exchange and related business assets in Maine, New Hampshire and Vermont, spin-off that new entity into a newly formed company, known as Northern New England Spinco Inc. (Spinco), to Verizon's shareowners, and immediately merge it with and into FairPoint.

On March 31, 2008, Verizon completed the spin-off of the shares of Spinco to Verizon shareowners and the merger of Spinco with FairPoint, resulting in Verizon shareowners collectively owning approximately 60 percent of FairPoint common stock. FairPoint issued approximately 53.8 million shares of FairPoint common stock to Verizon shareowners in the merger, and Verizon shareowners received one share of FairPoint common stock for every 53.0245 shares of Verizon common stock they owned as of March 7, 2008. FairPoint paid cash in lieu of any fraction of a share of FairPoint common stock.

Verizon also entered into other agreements that defined responsibility for obligations arising before or that may arise after the spin-off, including, among others, obligations relating to Verizon employees whose primary duties relate to Spinco's business, certain transition services and taxes. In general, the agreements governed the exchange of services between us and FairPoint through January 2009 at specified cost-based or commercial rates.

The consolidated income statements for the periods presented include the results of operations of the local exchange and related business assets in Maine, New Hampshire and Vermont through March 31, 2008, the date of completion of the spin-off. The consolidated balance sheet as of March 31, 2008 reflects the spin-off activities. The existing asset base was reduced by $1,878 million, including net plant, property and equipment of $1,596 million; total liabilities were decreased by $1,080 million, including a reduction in debt of $540 million; and contributed capital was increased by $362 million. In addition, we also recorded an increase in notes receivable from affiliate of $1,160 million, associated with the cash we received from the FairPoint transaction. Subsequently, on April 3, 2008, we used this cash to pay a dividend in the amount of $1,160 million to our parent, Verizon Communications Inc., reducing our contributed capital position by that amount.

During 2008, Verizon recorded pretax charges of $103 million ($81 million after-tax) for costs incurred related to the separation of the wireline facilities and operations in Maine, New Hampshire and Vermont from Verizon at the closing of the transaction, as well as for professional advisory and legal fees in connection with this transaction. Of this amount, we recorded $18 million ($13 million after-tax). During 2007, Verizon recorded pretax charges of $84 million ($80 million after-tax) for costs incurred related to the separation of the wireline facilities and operations in Maine, New Hampshire and Vermont. Of this amount, we recorded $31 million ($26 million after-tax).

Basis of Presentation

We prepare our financial statements using U.S. generally accepted accounting principles 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 long-lived assets, unrealized tax benefits, and pension and postretirement benefit assumptions.

The consolidated financial statements include the accounts of Verizon New England Inc. and its subsidiary. All significant intercompany accounts and transactions have been eliminated. We have a 33-1/3% ownership interest in Telesector Resources Group, Inc. (d/b/a Verizon Services Group) and share voting rights equally with the other owner, Verizon New York Inc. (Verizon New York), which is a wholly owned subsidiary of NYNEX. Verizon Services Group operates in conjunction with Verizon Services Corp. and Verizon Corporate Services Group Inc. (collectively known as Verizon Services) to provide various centralized services on behalf of Verizon's subsidiaries. We use the equity method of accounting for our investment in Verizon Services Group. We also have a 4.57% ownership interest in SMS/800, a venture that is jointly owned by the former Bell Operating Companies. SMS/800 administers the centralized national database system associated with toll free numbers. We use the equity method of accounting for our investment in SMS/800.

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

Revenue Recognition

We recognize service revenues based upon usage of our local exchange network and facilities and contract fees. Fixed fees for local telephone, long distance and certain other services are recognized in the month the service is provided. Revenue from other products that are not fixed fee or that exceed contracted amounts is recognized when such services are provided. We recognize revenue for services, in which we bundle the equipment with maintenance and monitoring services, when the equipment is installed in accordance with contractual specifications and ready for the customer's use. The maintenance and monitoring services are recognized monthly over the term of the contract as we provide the services. Long-term contracts are accounted for using the percentage of completion method. We use the completed contract method if we cannot estimate the costs with a reasonable degree of reliability.

Non-recurring customer activation fees, along with the related costs up to, but not exceeding the activation 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 that are within the scope of Emerging Issues Task Force (EITF) No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement* (EITF No. 06-3) in the consolidated financial statement 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, to Cost of services and sales as these costs are incurred.

Cash and Cash Equivalents

We consider all highly liquid investments with a maturity of 90 days or less when purchased to be cash equivalents. Cash equivalents are stated at cost, which approximates market value and include amounts held in money market funds.

Short-term Investments

Our short-term investments, which are stated at fair value, consist of cash equivalents held in trust to pay for certain employee benefits. The decline in Short-term investments at December 31, 2008 was due to a decrease in the annual trust funding.

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 and the aging of the receivables, among other factors, such as overall economic conditions.

Material and Supplies

Material and supplies include new and reusable supplies and network equipment which are stated principally at average original cost, except that specific costs are used in the case of large individual items.

Plant and Depreciation

We record 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 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 are presented in the following table:

Average Lives (in years)	
Buildings	45
Central office equipment	5-11
Outside communications plant	
Copper cable	14-16
Fiber cable	20-25
Poles and conduit	30-50
Furniture, vehicles and other	5-15

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

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

Annually, we review the estimated useful lives of plant, property and equipment along with the associated depreciation rates. Effective January 1, 2009 the average useful lives of fiber cable was increased to 25 years from 20 to 25 years and the average useful lives of copper cable would be changed to 15 years from 14 to 16 years. Effective January 1, 2008, the average useful lives of fiber cable was increased from 20 years to 20 to 25 years. As a result, 2008 depreciation expense decreased by $18 million ($11 million after tax). Effective January 1, 2007, the life for buildings was increased to 45 years from a previous range of 25 to 42 years. As a result, 2007 depreciation expense decreased by $14 million ($8 million after tax). In addition, the life for circuit equipment was increased from 8 to 9 years, effective January 1, 2007. This resulted in a decrease in 2007 depreciation expense of $39 million ($24 million after tax).

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, the ongoing plans to roll out the broadband network, technology upgrades and enhancements, planned retirements, and the adequacy of reserves.

Impairment of Long-Lived Assets

Our plant, property and equipment and intangible assets that do not have indefinite lives are amortized over their useful lives and reviewed for impairment in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS No. 144), whenever events or changes in circumstances indicate that the carrying amount of the asset 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.

Computer Software Costs

We capitalize the cost of network and non-network software which has a useful life in excess of one year in accordance with Statement of Position (SOP) No. 98-1*, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. Subsequent additions, modifications or upgrades to the 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 non-network software. Capitalized non-network computer software costs are amortized using the straight-line method over a period of 5 to 7 years.

Intangible Assets

Our intangible assets consist of non-network software and franchise fees are as follows:

(dollars in millions)

	At December 31, 2008		At December 31, 2007	
	Gross Amount	**Accumulated Amortization**	Gross Amount	Accumulated Amortization
Non-network software (5 to 7 years)	**$ 26**	**$ 25**	$ 66	$ 58
Franchise fees (5 to 15 years)	**11**	**1**	1	---

Intangible asset amortization expense was $8 million and $13 million for the years ended December 31, 2008 and 2007, respectively and is estimated to be $2 million in 2009, $1 million in 2010, $1 million in 2011, $1 million in 2012 and $1 million in 2013.

Advertising Costs

Advertising costs for advertising products and services are charged to Selling, general and administrative expense in the period 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 nonqualified stock options, incentive stock options, restricted stock, restricted stock units, performance shares, performance share units and other awards.

On April 1, 2008, the number of shares of restricted stock units (RSUs) and performance stock units (PSUs) previously issued by Verizon were adjusted pursuant to the terms of the applicable Verizon equity incentive plans, taking into account the change in the value of Verizon common stock as a result of the spin-off.

Restricted Stock Units

The Plan provides for grants of RSUs that generally vest at the end of the third year after the grant. The RSUs are classified as liability awards because the RSUs are 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's stock. Dividend equivalent units are also paid to participants at the time the RSU award is paid.

Performance Share Units

The Plan also provides for grants of 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 Communications Inc. determines the number of PSUs a participant earns based on the extent to which the corresponding goals have been achieved over the three-year performance cycle. All payments are subject to approval by Verizon 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's 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 employees at an option price per share of 100% of the fair market value of Verizon 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, 2008.

After-tax compensation expense for other stock-based compensation included in net income as reported for the years ended December 31, 2008 and 2007 was not material.

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 consolidated statements of operations 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 consolidated balance sheets (see Note 6).

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)* (SFAS No. 158). Effective December 31, 2006, SFAS No. 158 requires the recognition of a defined benefit postretirement plan's funded status as either an asset or liability on the balance sheet. SFAS No. 158 also requires the immediate recognition of the unrecognized actuarial gains and losses and prior service costs and credits that arise during the period as a component of Accumulated other comprehensive income (loss), net of applicable income taxes. Verizon adopted SFAS No. 158 effective December 31, 2006. Because of the structure of the plans, the SFAS No. 158 related adjustments recorded by Verizon to recognize the funded status are not reflected in the consolidated balance sheets as of December 31, 2008 or 2007.

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 SFAS No. 112, *Employers' Accounting for Postemployment Benefits—an amendment of FASB Statements No. 5 and 43* (SFAS No. 112). 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 consolidated statements of operations.

Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS No. 157). SFAS No. 157 defines fair value, establishes a framework for measuring fair value and establishes a hierarchy that categorizes and prioritizes the sources to be used to estimate fair value. SFAS No. 157 also expands financial statement disclosures about fair value measurements. Under SFAS No. 157, fair value 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. SFAS No. 157 also establishes a three-tier hierarchy for inputs used in measuring fair value, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

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.

On February 12, 2008, FASB issued FASB Staff Position (FSP) No. FAS 157-2, *Effective Date of FASB Statement No. 157* (FSP 157-2), which delays the effective date of SFAS No. 157 for one year for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis. We elected a partial deferral of SFAS No. 157 under the provisions of FSP 157-2 related to the measurement of fair value used when evaluating other intangible assets. On October 10, 2008, the FASB issued FSP 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* , (FSP 157-3), which clarifies application of SFAS No. 157 in a market that is not active. FSP 157-3 was effective upon issuance, including prior periods for which financial statements have not been issued. The impact of partially adopting SFAS No. 157 on January 1, 2008 and the related FSPs 157-2 and 157-3 was not material to our financial statements.

SFAS No. 159

SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of SFAS No. 115* (SFAS No. 159), permits but does not require us to measure financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. As we did not elect to fair value any of our financial instruments under the provisions of SFAS No. 159, our adoption of this statement effective January 1, 2008 did not have an impact on our consolidated financial statements.

Income Taxes

Verizon and its domestic subsidiaries, including us, file a consolidated federal income tax return. We participate in a tax sharing agreement with Verizon and remit tax payments to Verizon based on the respective tax liability determined as if on a separate company basis. Current and deferred tax expense/ (benefit) is determined by applying the provisions of SFAS No. 109, *Accounting for Income Taxes* (SFAS No. 109), to each subsidiary as if it were a separate taxpayer.

Effective January 1, 2007, we adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), which requires the use of a two-step approach for recognizing and measuring tax benefits taken or expected to be taken in a tax return and disclosures regarding uncertainties in income tax positions. 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. As a result of the implementation of FIN 48, we recorded adjustments to liabilities that resulted in a net $5 million increase in the liability for unrecognized tax benefits with an offsetting reduction to retained earnings as of January 1, 2007. In addition, we recorded an adjustment for our equity method investee that resulted in a $1 million increase to our investment with an offsetting reduction to reinvested earnings as of January 1, 2007.

We use the deferral method of accounting for investment tax credits earned prior to the repeal of investment tax credits by the Tax Reform Act of 1986. We also defer certain transitional credits earned after the repeal. We amortize these credits over the estimated service lives of the related assets as a reduction to the provision for income taxes.

Derivative Instruments

We employ risk management strategies to manage our exposure to fluctuations in interest rates. We do not hold derivatives for trading purposes.

In accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS No. 133) and related amendments and interpretations, we measure all derivatives, including derivatives embedded in other financial instruments, at fair value and recognize them as either assets or liabilities on our consolidated balance sheets. Changes in the fair values of derivative instruments not qualifying as hedges or any ineffective portion of hedges are recognized in earnings in the current period. Changes in the fair values of derivative instruments used effectively as fair value hedges are recognized in earnings, along with changes in the fair value of the hedged item. Changes in the fair value of the effective portions of cash flow hedges are reported in accumulated other comprehensive income (loss), and recognized in earnings when the hedged item is recognized in earnings.

2. PLANT, PROPERTY AND EQUIPMENT

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

At December 31,	2008	2007
	(dollars in millions)	
Land	**$ 18**	$ 32
Buildings	**729**	1,114
Central office equipment	**6,051**	8,224
Outside communications plant	**6,300**	8,616
Furniture, vehicles and other work equipment	**318**	438
Construction-in-progress	**42**	148
Other	**121**	154
	13,579	18,726
Less accumulated depreciation	**9,143**	12,615
Total	**$ 4,436**	$ 6,111

3. LEASES

We lease certain facilities and equipment for use in our operations under both capital and operating leases.

Capital lease amounts included in plant, property and equipment are as follows:

At December 31,	2008	2007
	(dollars in millions)	
Capital leases	**$ 4**	$ 11
Less accumulated amortization	**2**	3
Total	**$ 2**	$ 8

Total rent expense amounted to $163 million in 2008 and $222 million in 2007. Of these amounts, $90 million in 2008 and $153 million in 2007 were lease payments to affiliated companies.

This table displays the aggregate minimum rental commitments under noncancelable leases for the periods shown at December 31, 2008, excluding those with affiliated companies:

Years	Capital Leases	Operating Leases
	(dollars in millions)	
2009	$ 1	$ 74
2010	1	59
2011	---	27
2012	---	14
2013	---	8
Thereafter	---	10
Total minimum rental commitments	2	$ 192
Less interest and executory costs	---	
Present value of minimum lease payments	2	
Less current installments	1	
Long-term obligation at December 31, 2008	$ 1	

As of December 31, 2008 the total minimum sublease rental to be received in the future under a noncancelable capital sublease was $2 million.

4. DEBT

Debt Maturing Within One Year

Debt maturing within one year consists of the following at December 31:

	(dollars in millions)	
	2008	2007
Notes payable to affiliates:		
Verizon Investments Inc.	**$ 220**	$ ---
FSLLC	**---**	169
Long-term debt maturing within one year	**201**	2
Total debt maturing within one year	**$ 421**	$ 171
Weighted average interest rate for notes payable outstanding at year-end	**3.84%**	4.69%

We have contractual agreements with affiliated companies, Verizon Investments Inc. and Verizon Financial Services LLC (FSLLC), for the provision of financing and cash management services.

Long-Term Debt

Outstanding long-term debt obligations are as follows:

			(dollars in millions)	
At December 31,	**Interest Rate**	**Maturity**	**2008**	2007
Ten year notes payable	5.875%	2009	**$ 200**	$ 200
Ten year debenture	6.500	2011	**1,000**	1,000
Ten year debenture	4.750	2013	**300**	300
Forty year debenture	7.875	2029	**349**	349
			1,849	1,849
Interest rate swap liability			**55**	33
Other – long-term debt	8.000	2011	**2**	2
Unamortized discount and premium, net			**(3)**	(3)
Notes payable with affiliate (VNSHI)	5.350	2009	**---**	220
Notes payable with affiliate (FSLLC)	5.170	2010	**---**	125
Notes payable with affiliate (Verizon Investments Inc.)	2.176	2010	**125**	---
Notes payable with affiliate (FSLLC)	6.042	2012	**---**	480
Capital lease obligations			**2**	8
Total long-term debt, including current maturities			**2,030**	2,714
Less maturing within one year			**201**	2
Total long-term debt			**$ 1,829**	$ 2,712

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 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.

On March 30, 2008, we issued a $125 million note to an affiliated company, Verizon Investments Inc. The note matures on June 15, 2010 and carries a floating interest rate priced at 3 month LIBOR plus 18 basis points, reset and paid quarterly.

On March 30, 2008, we issued a $220 million note to an affiliated company, Verizon Investments Inc. The note matures on January 30, 2009 and carries a floating interest rate priced at 3 month LIBOR plus 37 basis points, reset and paid quarterly.

During the first quarter of 2008 the $125 million 5.17% note due 2010 to FSLLC as well as the $220 million 5.35% note due 2009 to VNSHI were repaid. In addition, as a result of the FairPoint transaction, the $480 million 6.042% note due 2012 was repaid.

On December 10, 2007, we issued a $480 million note to an affiliated company, FSLLC. The note matures on December 10, 2012 and carries a floating interest rate priced at 1 month LIBOR plus 80 basis points, reset and paid monthly.

On June 15, 2007, we issued a $125 million promissory note to an affiliated company, FSLLC. The note matures on June 15, 2010 and carries a floating interest rate priced at 3 month LIBOR plus 18 basis points, reset and paid quarterly.

During 2007 the $125 million 7.65% note matured and was repaid and during the fourth quarter of 2007, Verizon redeemed previously guaranteed $480 million 7.0% debentures, Series B, issued by the Company due 2042 at par plus accrued and unpaid interest to the redemption dates.

Maturities of long-term debt outstanding at December 31, 2008, excluding capital lease obligations and unamortized discount and premium are as follows:

Years	(dollars in millions)
2009	$ 200
2010	125
2011	1,002
2012	---
2013	300
Thereafter	349
Total long-term debt outstanding	$ 1,976

5. FINANCIAL INSTRUMENTS

Derivatives

The ongoing effect of SFAS No. 133 and related amendments and interpretations on our financial statements will be determined each quarter by several factors, including the specific hedging instruments in place and their relationships to hedged items, as well as market conditions at the end of each period. For the years ended December 31, 2008 and 2007, the mark to market of our interest rate swaps did not have a material effect on our results of operations or financial position.

We have entered into domestic interest rate swaps to achieve a targeted mix of fixed and variable rate debt, where we principally receive fixed rates and pay variable rates based on London Interbank Offered Rate (LIBOR). These swaps are designated as fair value hedges and hedge against changes in the fair value of our debt portfolio. We record the interest rate swaps at fair value in our balance sheet as assets and liabilities and adjust debt for the change in its fair value due to changes in interest rates. The fair value of interest rate swaps at December 31, 2008 included in other assets and long-term debt was $55 million.

The counterparties to the interest rate swap agreements are major financial institutions. These financial institutions have been accorded high ratings by primary rating agencies. We limit the dollar amount of contracts entered into with any one financial institution and monitor the credit ratings of these counterparties. We generally do not give or receive collateral on an interest rate swap agreement due to our credit rating and those of our counterparties. While we may be exposed to credit losses due to the nonperformance of our counterparties, we consider the risk remote and do not expect the settlement of these transactions to have a material effect on our results of operations or financial position.

Concentrations of Credit Risk

Financial instruments that subject us to concentrations of credit risk consist primarily of short-term investments, trade receivables and interest rate swap agreements. Concentrations of credit risk with respect to trade receivables, other than those from AT&T Inc., are limited due to the large number of customers. We generated revenues from services provided to AT&T (primarily network access and billing and collection) of $127 million in 2008 and $195 million in 2007.

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

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 demand note basis, therefore, the carrying value of the note receivable approximates its fair market value. As of December 31, 2008, we had a note receivable in the amount of $44 million from VNFC.

6. EMPLOYEE BENEFITS

We participate in Verizon's benefit plans. Verizon maintains non-contributory 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 non-contributory and include a limit on the Verizon's share of cost for recent and future retirees. Verizon also sponsor 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, 2008.

Pension and Other Postretirement Benefits

Pension and other postretirement benefits for the majority of our employees are subject to collective bargaining agreements. Approximately 88% 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:

(dollars in millions)

	Pension		Health Care and Life	
At December 31,	**2008**	2007	**2008**	2007
Net periodic benefit cost	**$ (12)**	$ 3	**$ 263**	$ 325
Termination benefits	**2**	---	**---**	---
Settlement loss	**12**	---	**---**	---
Curtailment loss	**---**	---	**2**	---
Subtotal	**14**	---	**2**	---
Total (income) cost	**$ 2**	$ 3	**$ 265**	$ 325

In 2008 we recorded a pension settlement loss of $12 million as lump-sum payments exceeded the threshold of service and interest costs. Also, we recorded expense of $2 million for retiree medical curtailments as a result of management downsizing. The settlement and curtailment of pension and retiree medical obligations are recorded in accordance with SFAS No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Pension Plans and for Termination Benefits* and SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other than Pensions*.

Amounts recognized in the consolidated balance sheets consist of:

(dollars in millions)

At December 31,	Pension		Health Care and Life	
	2008	2007	**2008**	2007
Prepaid pension asset	**$ 161**	$ 168	**$ ---**	$ ---
Employee benefit obligations	**20**	69	**1,745**	1,709

The changes in the employee benefit asset and obligations from year to year were caused by a number of factors, including changes in actuarial assumptions (see Assumptions) and settlements.

Assumptions

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

At December 31,	Pension		Health Care and Life	
	2008	2007	**2008**	2007
Discount rate	**6.75%**	6.50%	**6.75%**	6.50%
Rate of compensation increases	**4.00**	4.00	**N/A**	4.00

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

At December 31,	Pension		Health Care and Life	
	2008	2007	**2008**	2007
Discount rate	**6.50%**	6.00%	**6.50%**	6.00%
Expected return on plan assets	**8.50**	8.50	**8.25**	8.25
Rate of compensation increases	**4.00**	4.00	**4.00**	4.00

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	
	2008	2007
Health care cost trend rate assumed for next year	**9.00%**	10.00%
Rate to which cost trend rate gradually declines	**5.00**	5.00
Year the rate reaches level it is assumed to remain thereafter	**2014**	2013

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). Only one plan currently has unallocated shares. 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 attributed to our participating employees. In addition to the ESOP, Verizon also maintains a savings plan for associate employees. We recorded total savings plan costs of $31 million in 2008 and $39 million in 2007.

Severance Benefits

The following table provides an analysis of our severance liability recorded in accordance with SFAS No. 112, *Employers Accounting for Postemployment Benefits* (SFAS No. 112):

				(dollars in millions)
Year	**Beginning of Year**	**Charged to Expense (a)**	**Payments**	**End of Year (b)**
2007	$ 23	$ 56	$ (20)	$ 59
2008	**59**	**26**	**(23)**	**62**

(a) Includes accruals for ongoing employee severance costs and $22 million of special charges in 2008 and $49 million of special charges in 2007.

(b) The remaining severance liability includes future contractual payments to employees separated as of the end of the year.

7. FAIR VALUE MEASUREMENTS

The following table presents the balances of asset balances measured at fair value on a recurring basis as of December 31, 2008:

				(dollars in millions)
	Level (1)	**Level (2)**	**Level (3)**	**Total**
Assets:				
Short-term investments	$ ---	$ 22	$ ---	$ 22
Other assets	---	55	---	55

(1) – quoted prices in active markets for identical assets or liabilities
(2) – observable inputs other than quoted prices in active markets for identical assets and liabilities
(3) – no observable pricing inputs in the market

Short-term investments include a fund comprised of cash equivalents held in trust for the payment of certain employee benefits and are classified as Level 2. These temporary cash investments are stated at fair value using matrix pricing as they are not actively traded in an established market.

Our derivative contracts, included in Other assets or Other liabilities, are primarily comprised of interest rate swaps, are valued using models based on readily observable market parameters for all substantial terms of our derivative contracts and thus are classified within Level 2. As permitted by SFAS No. 157, we use mid-market pricing for fair value measurements of our derivative instruments.

The fair value of our short-term and long-term 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 long-term and short-term debt, excluding capital leases, was $2,158 million and $2,924 million at December 31, 2008 and 2007, respectively, as compared to the carrying value of $2,193 million and $2,842 million, respectively at December 31, 2008 and 2007.

8. INCOME TAXES

The components of income tax expense (benefit) are presented in the following table:

Years Ended December 31,	(dollars in millions) 2008	2007
Current:		
Federal	**$ 15**	$ 166
State and local	**14**	27
	29	193
Deferred:		
Federal	**(34)**	(147)
State and local	**(17)**	(27)
	(51)	(174)
Investment tax credits	**(1)**	(1)
Total income tax (benefit) expense	**$ (23)**	$ 18

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

Years Ended December 31,	(dollars in millions) 2008	2007
Federal income tax at statutory rate	**$ (9)**	$ 20
State income taxes, net of federal tax benefits	**(2)**	1
Investment tax credits	**(1)**	(1)
Equity investments	**(6)**	(5)
Medicare subsidy	**(9)**	(7)
Non-deductible expenses	**2**	7
Other, net	**2**	3
Income tax (benefit) expense	**$ (23)**	$ 18

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) 2008	2007
Deferred tax assets:		
Employee benefits	**$ 724**	$ 665
Allowance for uncollectible accounts	**31**	37
Investment tax credits	**3**	6
Contingencies/Reserves	**49**	38
Other- assets	**9**	21
Deferred tax assets	**816**	767
Deferred tax liabilities:		
Depreciation	**776**	1,028
Other – liabilities	**3**	15
Deferred tax liabilities	**779**	1,043
Net deferred tax (asset) liability	**$ (37)**	$ 276

FASB Interpretation No. 48

FIN 48 prescribes the recognition, measurement and disclosure standards for uncertainties in income tax positions. A reconciliation of the beginning and ending balance of unrecognized tax benefits is as follows:

	(dollars in millions)	
	2008	2007
Balance at January 1,	**$ 71**	$ 101
Additions based on tax positions related to the current year	**21**	7
Additions for tax positions of prior years	**5**	9
Reductions for tax positions of prior years	**(28)**	(46)
Settlements	**(14)**	---
Lapses of statutes of limitations	**---**	---
Balance at December 31,	**$ 55**	$ 71

Included in the total unrecognized tax benefits at December 31, 2008 and 2007 is $5 million and $7 million, respectively, that, if recognized, would favorably affect the effective income tax rate.

We recognize any interest and penalties accrued related to unrecognized tax benefits in income tax expense. During the year ended December 31, 2008 we recognized a net after tax benefit in the income statement related to interest and penalties of approximately $4 million. We had approximately $10 million (after-tax) and $14 million (after-tax) for the payment of interest and penalties accrued in the balance sheets at December 31, 2008 and December 31, 2007, respectively.

During the year ended December 31, 2007, we recognized approximately $5 million (after-tax) for the payment of interest and penalties. We had approximately $14 million (after-tax) and $9 million (after-tax) for the payment of interest and penalties accrued in the balance sheets at December 31, 2007 and January 1, 2007, respectively.

Verizon or one of its domestic subsidiaries files income tax returns in the U.S. federal jurisdiction and various state and local jurisdictions. Verizon is generally no longer subject to U.S. federal, state and local income tax examinations by tax authorities for years before 2004. The Internal Revenue Service will begin its examination of Verizon's U.S. income tax returns for the years 2004 through 2006 in the first quarter of 2009. As a result of the anticipated resolution of various income tax audits within the next twelve months, we believe that it is reasonably possible that the amount of unrecognized tax benefits will decrease. An estimate of the range of the possible change cannot be made until issues are further developed.

9. TRANSACTIONS WITH AFFILIATES

Our consolidated financial statements include transactions with the following affiliates:

Years Ended December 31,	2008	(dollars in millions) 2007
Operating revenues:		
Verizon Internet Services Inc.	**$ 353**	$ 372
Verizon Business	**157**	200
Verizon Wireless Inc.	**36**	49
Verizon Services	**34**	43
Verizon Long Distance	**33**	51
Verizon Operating Telephone Companies	**4**	4
Other	**---**	2
	$ 617	$ 721
Operating expenses:		
Verizon Services	**$ 687**	$ 884
Verizon Data Services Inc.	**105**	70
GTE Communication Systems Corporation	**19**	2
Verizon Wireless Inc.	**5**	3
Verizon Business	**4**	6
Verizon Operating Telephone Companies	**---**	3
	$ 820	$ 968
Other income and (expense), net:		
Equity income (loss) from investees	**$ 17**	$ 14
Interest income from Verizon Network Funding Corp.[1]	**7**	2
Interest income from Verizon Services	**---**	2
	$ 24	$ 18
Interest expense:		
Interest expense to Verizon Investments Inc.	**$ 10**	$ ---
Interest expense to Verizon Financial Services LLC	**8**	2
Interest expense to Verizon NSI Holdings Inc.	**4**	16
Interest expense to Verizon Network Funding Corp.	**---**	8
	$ 22	$ 26
Return of capital to NYNEX	**$ 1,160**	$ ---
Capital Contribution from NYNEX	**$ 344**	$ ---
Dividends paid to NYNEX	**$ ---**	$ 50
Dividends received from affiliates	**$ 19**	$ 12

Outstanding balances with affiliates are reported on the consolidated balance sheets at December 31, 2008 and 2007 as Notes Receivable from Affiliate, Accounts Receivable from Affiliates, Notes Payable to Affiliate, Accounts Payable and Accrued Liabilities to Affiliates and Long – term Debt – Notes Payable to Affiliates.

Verizon Internet Services Inc.

Our operating revenues include transactions with Verizon Internet Services Inc. (Verizon Internet Services) associated with the provision of network access and billing and collection services. These revenues are earned from Verizon Internet Services who utilizes our facilities to provide Internet access services to their customers.

[1] FSLLC and VNFC

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 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 and for the rental of facilities and equipment.

We have contractual arrangements with Verizon Services 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 Long Distance

Our operating revenues include transactions with Verizon Long Distance who utilizes our facilities to provide long distance services to their customers. We record revenue in connection with the provision of billing and collection services, including programming charges associated with billing system changes.

Verizon Operating Telephone Companies

Our operating revenues and expenses 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. We also earn revenue from fees associated with the termination of their customer's calls on our network. In addition, we also recognize expenses associated with transactions with these affiliates. These costs are primarily associated with the rental of their facilities and equipment.

Verizon Data Services Inc.

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

GTE Communication Systems Corporation

GTE Communication Systems Corporation (GTE Communication Systems) provides construction and maintenance equipment, supplies and electronic repair services to us. We record these purchases and services at cost, including a return realized by GTE Communication Systems.

Verizon Network Funding Corp., Verizon Financial Services LLC, Verizon NSI Holdings Inc and Verizon Investments Inc.

We recognize interest expense/income in connection with contractual agreements with affiliated companies, Verizon Network Funding Corp. (VNFC), Verizon Financial Services LLC (FSLLC) and Verizon Investments Inc., for the provision of short-term financing and cash management services. We also recognized interest expense related to a promissory note held by Verizon NSI Holdings Inc., which was assigned over to Verizon Investments Inc. in March 2008.

Other Affiliates

Other operating revenues include miscellaneous items of income and expense resulting from transactions with other affiliates. These transactions include the provision of local and network access services, billing and collection services, rental of facilities and equipment, electronic repair services, and sales and purchases of material and supplies.

10. ADDITIONAL FINANCIAL INFORMATION

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

	(dollars in millions)	
Years Ended December 31,	**2008**	2007
Cash Flow Information:		
Cash paid during the year for:		
Income taxes (refunded)/paid, net	**$ (13)**	$ 204
Interest, net of amounts capitalized (excluding affiliates)	**98**	149
Income Statement Information:		
Depreciation expense	**649**	853
Interest costs incurred	**125**	184
Advertising expense (allocated to us by Verizon Services)	**52**	45
Capitalized interest	**(8)**	(12)

11. 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.

12. SUBSEQUENT EVENT

On January 30, 2009, we issued a $220 million note to an affiliated company, Verizon Investments Inc. The note matures on January 30, 2014 and carries a floating interest rate priced at 3 month LIBOR plus 325 basis points, reset and paid quarterly.