BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Petition of Verizon Florida Inc. To Reform Its UNE Cost of Capital and Depreciation Inputs To Comply with the FCC's Guidance in *Triennial Review Order*	Docket No. 050059-TL

DIRECT TESTIMONY OF

ANTHONY J. FLESCH

ON BEHALF OF

VERIZON FLORIDA INC.

DEPRECIATION

JANUARY 25, 2005

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I. **WITNESS BACKGROUND**

Q. **PLEASE STATE YOUR NAME, ADDRESS AND CURRENT POSITION.**

A. My name is Anthony J. Flesch. My business address is 600 Hidden Ridge, Irving, Florida 75038. I am Sr. Staff Manager - Capital Recovery for Verizon Services Organization Inc.

Q. **PLEASE BRIEFLY DESCRIBE YOUR EDUCATIONAL BACKGROUND.**

A. I received a Bachelor of Science Degree in Business Administration from Indiana Wesleyan University in Marion, Indiana. I have completed basic and advanced courses in depreciation life analysis, methods, and technology forecasting.

I have developed and taught courses on depreciation life analysis, obsolescence and technology forecasting provided by the Society of Depreciation Professionals ("SDP"). The goal of SDP is to recognize and promote professional development and ethics within the field of depreciation and provide information of interest to depreciation professionals.

I am currently a Senior Member of the SDP and have served on the SDP Executive Board of Directors in several capacities, including President, Vice-President, Director, and Chair of the SDP Ethics and Standards Committee. I am now serving as Chair of the SDP Education and Training Administration Subcommittee, SDP Journal Editor and Chair of the Journal Review Committee, and as a member of the SDP Current Issues Committee.

I am also a member of the Telecommunications Technology Forecasting Group ("TTFG"). TTFG is an industry association which was formed in 1985 to support the understanding and use of technology forecasting to predict and forecast the continued evolution of the telecommunications network. I have been on the advisory board of TTFG since 1994, and have been Chairman of TTFG since 2003.

Q. PLEASE BRIEFLY DESCRIBE YOUR WORK EXPERIENCE WITH VERIZON AND YOUR RESPONSIBILITIES IN YOUR CURRENT POSITION.

A. I have worked for Verizon (or one of its predecessor companies) for over twenty-eight years, with seventeen of those years in the depreciation study area. I have held various positions of increasing responsibility in Engineering and Construction, Network Operations, and Finance. I was named to my current position in June of 2000.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION?

A. Yes. I gave an oral deposition on January 21, 2004, and, in Docket No. 981834-TP, adopted the direct and surrebuttal depreciation testimonies of Verizon witness Sovereign.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE ANY OTHER REGULATORY OR JUDICIAL BODIES?

A. Yes, I have presented written or oral testimony before state commissions in Alabama, Arkansas, California, Florida, Illinois, Minnesota, Missouri, Nebraska, Nevada, North Carolina, and Washington. I have also testified before the Twelfth Judicial Circuit in and for Desoto, Manatee and Sarasota Counties in the state of Florida on depreciation issues related to property tax.

II. OVERVIEW OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR DIRECT TESTIMONY?

A. The purpose of my testimony is twofold. First, I explain that the depreciation lives established in Verizon's last UNE proceeding (i.e., Docket No. 990649B-TP) do not reflect the *Triennial Review Order's* mandate that depreciation lives must reflect a fully competitive market.[1] Second, I explain that the depreciation lives proposed in this proceeding by Verizon are consistent with that mandate, and therefore should be adopted here.

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. My testimony explains that depreciation lives adopted in Verizon's last UNE rate proceeding are unlawful because they are not company-specific, and do not reflect a fully-competitive facilities-based market, as

[1] Report and Order and Order on Remand, *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, CC Docket Nos. 01-338, 96-98-98-147 at ¶¶ 685, 689 (rel. Aug. 21, 2003) ("*Triennial Review Order*").

required by TELRIC and clarified in the *Triennial Review Order*

My testimony also makes clear why depreciation lives determined according to generally accepted accounting principles ("GAAP") should be used to compute economic depreciation when setting UNE rates. Depreciation lives, set in accordance with GAAP, are the best available lives for computing the actual, forward-looking, anticipated economic life of assets. GAAP lives appropriately account for the anticipated impact of future technologies (and thus are inherently forward-looking), as well as actual and anticipated competition. In addition, GAAP lives are relevant and reliable, as required by GAAP and the Securities and Exchange Commission ("SEC"). As a result they provide an up-to-date estimate of the period during which Verizon's assets will continue to produce economic value. Accordingly, GAAP lives are appropriate to use in setting UNE rates to comply with the FCC's mandate that UNE rates be set based on the incumbent's economic depreciation in a fully competitive telecommunications market.

Finally, my testimony shows that the specific depreciation lives and net salvages proposed here by Verizon were prepared in accordance with GAAP, reflect the economic lives of network assets, and are fully consistent with the FCC's total element long-run incremental cost ("TELRIC") requirements. Indeed Verizon's use of GAAP lives in this proceeding is conservative because the Company experiences unique risks associated with providing UNEs to CLECs – risks not faced by other carriers. For example, competitors may use Verizon's UNEs for only a short period and then use their own facilities, leaving Verizon with undepreciated costs to be written off as a loss, resulting in stranded facilities.

III. THE FCC'S FORWARD-LOOKING DEPRECIATION REQUIREMENT

Q. WHAT GUIDANCE DOES THE FCC'S TRIENNIAL REVIEW ORDER PROVIDE TO STATE COMMISSIONS REGARDING THE ESTABLISHMENT OF FORWARD-LOOKING DEPRECIATION LIVES TO BE USED FOR SETTING UNE RATES?

A. In the Triennial Review Order, the FCC confirmed that the TELRIC methodology requires that the depreciation inputs of UNE rates "should reflect any factors that would cause a decline in asset values, such as *competition and advances in technology.*"[2] Specifically, the FCC clarified that in "calculating depreciation expense, there, the rate of depreciation over the useful life should reflect the actual decline in value that would be anticipated in the *competitive market TELRIC assumes.*"[3]

The Triennial Review Order explicitly holds that the various components of TELRIC rates, including depreciation lives, must be developed using a consistent set of assumptions about competition:

> The objective of TELRIC is to establish a price that replicates the price that would exist in a market in

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[2] *Triennial Review Order* at ¶ 685 (emphasis added).

[3] *Id.* at ¶ 689 (emphasis added).

> which there is *facilities-based competition.* In this type of competitive market, all facilities-based carriers would face the risk of losing customers to other facilities-based carriers, and that risk should be reflected in TELRIC prices.[4]

Thus, under TELRIC, depreciation lives must reflect forward-looking, fully competitive markets in which Verizon faces the real risk of losing customers.[5]

Q. WHEN WAS THE *TRIENNIAL REVIEW ORDER* RELEASED BY THE FCC?

A. The FCC released the *Triennial Review Order* on August 21, 2003.

IV. THE DEPRECIATION LIVES ADOPTED IN VERIZON'S LAST UNE RATE PROCEEDING DO NOT COMPLY WITH THE REQUIREMENTS OF THE TRIENNIAL REVIEW ORDER.

Q. WHAT DEPRECIATION LIVES DID THIS COMMISSION APPROVE IN VERIZON'S LAST UNE RATE PROCEEDING (DOCKET NO. 990649B-TP)?

A. In Verizon's last UNE rate case, the Commission approved BellSouth's depreciation lives for Verizon.

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[4] *Id.* at ¶ 680 (emphasis added).

[5] *Id.* at ¶¶ 680, 685, 689. Verizon witness Dr. Vander Weide also discusses the *Triennial Review Order* and its TELRIC requirements for capital costs, depreciation and cost of capital in sections II and III of his direct testimony that is being filed concurrently with my direct testimony.

Q. WHEN WAS THE ORDER IN VERIZON'S LAST UNE PROCEEDING ISSUED BY THE COMMISSION?

A. The order was issued November 15, 2002, approximately eight months before the FCC's *Triennial Review Order*.

Q. DO THE DEPRECIATION LIVES APPROVED IN VERIZON'S LAST UNE RATE PROCEEDING APPROPRIATELY REFLECT DEVELOPMENTS IN COMPETITION AND TECHNOLOGICAL CHANGE?

A. No. First, the Commission approved BellSouth's depreciation lives for Verizon, so the Verizon lives are not company specific. This is significant because Verizon's territory is concentrated in the highly competitive Tampa/St. Petersburg area, whereas BellSouth operates throughout the state in various demographic and geographic areas. Second, the existing depreciation inputs do not reflect a fully-competitive facilities-based market, as required by TELRIC and clarified in the *Triennial Review Order*. The BellSouth depreciation lives applied to Verizon are based on the depreciation lives recommended by BellSouth, CLECs and CLEC groups.[6] In the BellSouth proceeding, the witness for AT&T/WorldCom testified that "his recommendations are generally consistent with the lives set forth in the FCC's 1995 prescription of BellSouth's depreciation rates."[7] BellSouth's witness made clear that

[6] BellSouth's UNE rates were established in Docket No. 990649A-TP by Order No. PSC-01-1181-FOF-TP, issued on May 25, 2001 (*BellSouth UNE Order*). *See BellSouth UNE Order* at 170-73.

[7] *Id.* at 158.

his recommendations are derived from BellSouth's 2000 Florida depreciation study.[8] Depreciation lives based on such outdated data do not reflect the principles of TELRIC and the effects of a fully competitive facilities-based telecommunications market. Consequently, the Commission should revise the depreciation input assumptions used to establish Verizon's UNE rates.

V. THE NEW DEPRECIATION LIVES RECOMMENDED BY VERIZON COMPLY WITH THE REQUIREMENTS OF THE TRIENNIAL REVIEW ORDER.

Q. WHAT DEPRECIATION INPUTS DOES VERIZON RECOMMEND THAT THE COMMISSION ADOPT HERE?

A. Verizon recommends that the Commission adopt the same forward-looking depreciation inputs that it uses in its external financial reports filed with the SEC and that it provides to its shareholders. These up-to-date depreciation lives, which have been reviewed by Verizon's external auditors and reported to the financial community, are consistent with GAAP. As explained further below, these GAAP lives take into account both increased competition and technological innovation, among other relevant factors. Appended to my testimony as Attachment A is a complete list of the proposed depreciation lives and future net salvage percentages that should be adopted here.

[8] *Id.* at 157.

A. GAAP LIVES FAIRLY AND RELIABLY MEASURE THE ECONOMIC DEPRECIATION EXPENSE ASSOCIATED WITH CAPITAL ASSETS.

Q. PLEASE EXPLAIN HOW GAAP DEPRECIABLE LIVES ARE DETERMINED.

A. GAAP depreciable lives are based upon the expected life during which the assets will produce economic benefits to the company. The goal is to allocate as equitably as possible the cost of using the depreciable asset over the period during which the company obtains economic benefits from the asset.

Q. ARE GAAP LIVES FORWARD-LOOKING?

A. Yes. GAAP lives are forward-looking because they are based upon the expected period of future economic benefit to the company. The initial assessment of useful life is made based upon the period of time during which the asset will produce economic benefits to the company from the date of acquisition. The remaining useful life of the asset is reassessed as financial reports are released to reflect events as they occur and circumstances as they change. Thus, GAAP lives are, by their very nature, forward-looking.

Q. PLEASE PROVIDE A BRIEF DESCRIPTION OF GAAP AND THE ORGANIZATIONS THAT ARE RESPONSIBLE FOR ESTABLISHING GAAP.

A. GAAP encompasses the conventions, rules and procedures that define accepted accounting practice at a particular time. Today, three bodies are responsible for establishing and revising GAAP: the Financial Accounting Standards Board (FASB), AcSEC, and the Emerging Issues Task Force of the FASB. All additions or modifications to GAAP must be approved by the FASB, the preeminent accounting standard-setting body in the United States, which, since 1973, has been designated by the SEC as the organization in the private sector responsible for establishing standards of financial accounting and reporting to be followed in the preparation of financial statements.[9] And the SEC has confirmed its confidence in the FASB in connection with the implementation of the Sarbanes-Oxley Act of 2002.[10]

Q. HOW ARE CAPITAL EXPENDITURES INITIALLY RECORDED AND DEPRECIATED UNDER GAAP?

A. A capital expenditure is initially recorded as an asset and then is charged to expense as its future economic benefits expire.[11] Upon acquisition, the expenditure is recorded as an asset in the amount of the acquisition cost. At the same time, the useful life to the company and the residual value expected upon disposition (positive or negative) is initially assessed. The process of allocating the cost of using the asset (the difference between the acquisition cost and residual value expected upon disposition) over its useful life also begins upon acquisition. This process results in a systematic and rational allocation of the cost of

[9] SEC, Accounting Series Release No. 150 (Dec. 20, 1973).

[10] SEC, Accounting Series Release No. 8221 (Apr. 25, 1973).

[11] Financial Accounting Standards Board ("FASB") Concept Statement No. 6.

using the asset as a charge to the company's operating income over the time it produces economic benefits to the company.

Q. WHAT IS THE OBJECTIVE OF COMPUTING DEPRECATION USING GAAP PRINCIPLES?

A. The principal goal of depreciation computed using GAAP lives is to allocate as neutrally and equitably as possible the cost of using the depreciable asset over the period during which the company obtains economic benefits from the asset.[12] Depreciation computed using GAAP lives thus follows the matching principle that is the cornerstone of accrual accounting.[13]

As the original organization responsible for promulgating GAAP stated:

> Generally accepted accounting principles require that [the cost of a productive facility] be spread over the expected useful life of the facility in such a way as to allocate it as equitably as possible to the periods during which services are obtained from the use of the facility. This procedure is known as depreciation accounting, a system of accounting which aims to distribute the cost or other basic

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[12] GAAP lives thus are the same lives used in computing "economic depreciation," C.F.R. § 51.505(b)(3), which, as the *NPRM* notes, is a "method of reflecting anticipated declines in the net present value of an asset over the course of its useful life." *NPRM* ¶ 92.

[13] FASB Financial Accounting Concepts Statement 6, "Elements of Financial Statements," ¶ 146 (Dec. 1985) (The matching principle requires the "combined recognition of the revenues and expenses that result directly and jointly from the same transactions or other events.") (hereinafter FASB Concepts Statement 6).

value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation.[14]

Q. PLEASE EXPLAIN THE FACTORS THAT AFFECT THE DETERMINATION OF THE TIME THAT AN ASSET IS LIKELY TO PROVIDE ECONOMIC BENEFITS TO A COMPANY.

A. Many factors may affect the time during which an asset provides benefits to a company. For example, one factor that affects the depreciable life is the physical wearing out of an asset. Once an asset is physically worn out, it can no longer produce any economic benefits. Another important factor in determing the depreciable life is technological obsolescence.[15] Once an asset becomes technologically obsolete, it is no longer able to provide economic benefits to the company. Similarly, the entry of competitors into a marketplace typically reduces the expected future benefits to be derived from an asset, both because decreased use of the asset as some customers are lost to the new entrants means the asset produces less revenue than expected and competitive pressures may result in the introduction of new products and therefore may require earlier replacement with a new model or style

[14] American Institute of Certified Public Accountants, Accounting Research Bulletin 43, "Restatement and Revision of Accounting Research Bulletins," American Institute of Certified Public Accountants, June, 1953, Chapter 9, "Depreciation," (June, 1953) ¶ C5.

[15] Donald E. Kieso, Jerry J. Weygandt & Terry D. Warfield, *Intermediate Accounting* 551-52 (10th Ed. 2001).

of equipment.

GAAP requires that all these factors be considered in determining the depreciable life of an asset. As one leading accounting text explains, "an accountant should consider all relevant information, including (1) past experience with similar assets; (2) the asset's present condition; (3) the company's repair and maintenance policy; (4) current technological and industry trends; and (5) local conditions such as weather" in establishing useful lives for depreciable assets.[16] Another text states that asset lives set in accordance with GAAP must account for the "intended use of the asset, repair and maintenance policies and the vulnerability of the asset to obsolescence."[17]

Q. ONCE A GAAP DEPRECATION LIFE HAS BEEN SET, CAN IT BE CHANGED TO REFLECT CHANGED OR CURRENT CIRCUMSTANCES?

A. Yes. Taking the factors referred to above into consideration, when an asset is acquired, the period of expected benefit is initially estimated and assigned as the depreciable life. Under GAAP, throughout the asset's life, the remaining period of benefit is reassessed and revised as circumstances demand. As one leading accounting textbook explains, under GAAP, "[a]nnual depreciation expense should be reviewed periodically by management. If wear and tear or obsolescence indicates

[16] Belverd E. Needles, Jr., Marian Powers, *Financial Accounting* at 452 (6th Ed. 1998).

[17] Donald E. Kieso, Jerry J. Weygandt & Paul D. Kimmel, *Financial Accounting, Tools For Business Decision Making* at 423 (3rd Ed. 2004).

that annual depreciation is either inadequate or excessive, the depreciation expense amount should be changed."[18] Further, under the SEC's financial reporting requirements, Verizon and other public corporations must review their asset lives on at least an annual basis. *See* 17 C.F.R. §§ 210.4-01(a)(1), 210.3-01 & 210.2-02(b). For example, assume that an asset is initially assigned a life of ten years and one tenth of its cost is charged to depreciation expense during each of the first two years of its life. If during the third year of use it is determined that the remaining period of benefit is only six years – perhaps because of technological or competitive developments – the depreciable life will be shortened from ten years, to eight years (the two years already passed plus the six remaining years) and one sixth of the remaining undepreciated cost will be charged to expense over each of the remaining six years.

Q. PLEASE EXPLAIN THE TERM "ECONOMIC DEPRECIATION."

A. Economic depreciation is the change in value of a depreciable asset during the period of time over which an asset is used to provide economic value. Verizon's proposed depreciation inputs consider the decline in an asset's value from all causes, including competition and technological change. They reflect the principle that depreciation should be consistent with forward-looking economic assumptions and based on competitive market asset lives. As discussed above, the TELRIC requirement to use economic depreciation rates is designed to replicate

[18] *Id.* at 428.

the results that would be anticipated in a competitive market.[19]

Q. IS THE USEFUL LIFE FOR COMPUTING ECONOMIC DEPRECIATION CONSISTENT WITH THE LIFE USED TO COMPUTE DEPRECIATION UNDER GAAP?

A. Yes. Both GAAP depreciable life and economic depreciable life reflect the period during which an asset is expected to provide future economic benefits.[20]

Q. ARE THE ECONOMIC DEPRECIATION LIVES AND THE LIVES USED TO COMPUTE DEPRECIATION EXPENSE UNDER GAAP CONSISTENT WITH THE FCC'S TELRIC REQUIREMENTS?

A. Yes. Economic and GAAP depreciation lives reflect the forward-looking period during which the asset produces economic benefits to the company. Both concepts are designed to write the asset down from acquisition cost to the net residual value over the course of the asset's depreciable life. In fact, GAAP lives are probably too long because GAAP lives do not take into account the added risk inherent for those specific UNEs provided to CLECs. These risks include competition, in many forms, technological changes and the fact that competitive local exchange carriers can cease leasing UNEs even though Verizon is required to maintain its facilities.

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[19] Triennial Review Order at par. 689.

[20] *See, e.g.*, Carlton, Dennis and Perloff, Jeffrey M., *Modern Industrial Organization*, Addison Wesley, at 35.

Q. ARE GAAP DEPRECIATION LIVES SUBJECT TO SAFEGUARDS THAT ENSURE THEIR REASONABLENESS?

A. The GAAP asset lives used in financial reporting are subject to a number of safeguards that ensure that they comply with all relevant requirements. GAAP expressly requires that representations made in a company's financial statements, including statements reflecting depreciation expense, must be based on "evenhanded, neutral, or unbiased information."[21] Information can be deemed "neutral" only if it is free of any "bias intended to attain a predetermined result or to induce a particular mode of behavior."[22] Similarly, GAAP requires that information used in financial reports must be "reliable" and "relevant."[23] Under GAAP, information is "reliable" if there is "assur[ance] that [it] . . . is reasonably free from error and bias and faithfully represents what it purports to represent."[24] Likewise, financial information is "relevant" where it "help[s] users to form predictions about the outcomes of past, present, and future events or to confirm or correct prior expectations."[25]

These concepts of neutrality, reliability, and relevance must be followed in determining GAAP depreciable lives for depreciable assets. A company that has not followed these principles may not assert that its

[21] *Id.* at ¶ 33.

[22] *Id.* Glossary.

[23] FASB Statement of Financial Accounting Concepts No. 2, "Qualitative Characteristics of Accounting Information," Figure 1 at 20(May 1980) (hereinafter FASB Concepts Statement 2).

[24] *Id.* Glossary.

[25] *Id.* Glossary.

financial statements, including the computation of depreciation using the company's depreciable lives, are in conformity with GAAP.

Q. ARE GAAP LIVES SUBJECT TO AN INDEPENDENT AUDIT UNDER FEDERAL LAW?

A. Yes. As I have noted, under federal law, the financial statements of public companies (including their computations of depreciation expense) are subject to independent audit to ensure that they are in conformity with GAAP. 17 C.F.R. § 210.3-01; *see also id.* § 210.2-02(b). In fact, as a result of the Sarbanes-Oxley Act of 2002, the Chief Executive Officer and Chief Financial Officer of a public corporation now also must certify that the company's financial statements fairly present the financial condition and results of the company. *See* 17 C.F.R. § 229.601. This provides yet another safeguard with respect to the fairness of the GAAP lives a company uses in its financial statements.

Q. WHAT IS INCLUDED IN VERIZON'S FINANCIAL STATEMENTS?

A. The financial statements, on which the auditors opine, include the following: (1) an income statement that reports on the results of operations for the period; (2) the balance sheet that reports the financial position at a specified date; (3) a statement of cash flows that reports on the sources and uses of cash for the period presented; and (4) the notes to the financial statements.

Q. WHERE IS DEPRECIATION REFLECTED IN THE FINANCIAL STATEMENTS?

A. Depreciation is an integral part of the computation of net income on the income statement and total assets on the balance sheet. The owners' equity on the balance sheet is also affected directly by depreciation, both because net income becomes part of owners' equity and because owners' equity is the difference between assets and liabilities. Also, the statement of cash flows usually discloses the amount of depreciation expense. The depreciation method, depreciable lives, and additional disclosures about depreciation are also included in the notes to the financial statements.

Q. DOES VERIZON HAVE THE INCENTIVE TO REPORT LIVES THAT ARE UNREASONABLY SHORT IN ITS FINANCIAL STATEMENTS?

A. No. Verizon has no incentive to establish unreasonably short lives. As explained above, these lives are used to compute depreciation expense in Verizon financial statements prepared for investors and creditors. Market forces exert considerable pressure on public companies not to understate the lives of their capital assets. Shorter depreciable lives produce higher expenses, lower net income, and lower asset values, all of which are negative signals to investors that may lead to lower investor expectations and lower stock prices. These same financial statement effects, caused by shorter lives, could also be a concern to creditors, making it more difficult and expensive for a company to borrow. Thus, a company would have no rational incentive to *understate* depreciation lives. This is particularly true for Verizon (and other facilities-based telecommunications companies), because depreciation is one of its largest expense items.

Net income, moreover, is an important factor considered as part of management performance and has a direct (where management salary or bonus is dependent on earnings) and indirect (through stock option compensation and overall management reputation) effect on management compensation. Thus, the use of biased, shorter depreciable lives would have negative implications for managers' compensation.

Also, since ILECs use GAAP depreciation lives in a variety of contexts outside of UNE pricing, it is unreasonable to believe that a company would shorten GAAP lives simply for use in UNE rate cases. The possibility that these shorter lives *might* be adopted in a UNE rate case simply would not provide a rational incumbent with an incentive to adopt such depreciation lives across the board given the serious negative consequences that this would have for the company's financial statements and its credibility in the marketplace.

In short, Verizon has the economic incentive to use realistic and reasonable depreciable lives in its financial statements.

VI. VERIZON'S PROPOSED DEPRECIATION LIVES ARE CONSISTENT WITH GAAP AND THE PRINCIPLES OF TELRIC.

Q. DO VERIZON'S PROPOSED DEPRECIATION LIVES FOLLOW GAAP?

A. Yes, the factors Verizon considered in determining depreciation lives follow GAAP principles.

Q. PLEASE EXPLAIN GENERALLY HOW VERIZON DEVELOPED ITS PROPOSED ECONOMIC LIVES.

A. To determine its proposed economic lives, Verizon considered current network modernization strategies; the likely future impact of technology and obsolescence; the competitive environment in the forward-looking marketplace; regulatory commitments; state demographics; and traditional wear and tear. Verizon also "benchmarked" lives currently used by other companies and reviewed independent industry studies of technology obsolescence.

While all of the above factors interrelate in determining the proper forward-looking economic lives used in Verizon's cost studies, the most important are the functional factors — in particular, competition and technological innovation — that reduce the depreciable value of an asset even though the asset remains "physically" intact. Technological and competitive changes are particularly important in setting economic lives for use in TELRIC studies, because TELRIC assumes a fully competitive market.

Q. PLEASE EXPLAIN IN MORE DETAIL HOW VERIZON APPLIED THE VARIOUS FACTORS THAT DETERMINE ECONOMIC LIVES.

A. Verizon first considered the National Association of Regulatory Utility Commissioners' ("NARUC") factors relating to the retirement of assets. These include:

1. Physical Factors
   a. Wear and tear
   b. Decay or deterioration
   c. Action of the elements and accidents

2. Functional Factors
   a. Inadequacy
   b. Obsolescence
   c. Changes in Art and Technology
   d. Changes in Demand
   e. Requirements of Public Authority
   f. Management Discretion

3. Contingent Factors
   a. Casualties or Disasters
   b. Extraordinary Obsolescence[26]

Verizon used these same factors to help estimate an asset's economic life expectancy by allocating the appropriate weighting to each factor to

[26] *Public Utility Depreciation Practices*, National Association of Regulatory Utility Commissioners ("NARUC") at 14-15 (1996).

reflect the significant roles competition and technological change play in determining an asset's economic life. For example, the "Functional Factors" (Part 2 of the NARUC factors noted above) are sensitive to competition and technological change, and therefore, were given substantially greater weight than other factors in establishing the economic lives of Verizon's assets. For the technology-driven accounts — digital switching account, circuit equipment account, and cable — the functional factors were given virtually exclusive weight relative to the other factors listed above. Verizon took a more traditional approach for the determination of economic lives for the remaining accounts, which are less dependent on technological change. For example, in accounts such as motor vehicles or furniture, past patterns of retirement may be more useful in predicting future economic lives.

Q. WHAT KINDS OF COMPETITIVE DEVELOPMENTS WERE CONSIDERED IN ESTABLISHING VERIZON'S ECONOMIC LIVES?

A. As Dr. Vander Weide explains in detail in his testimony, actual competition is extensive throughout the local exchange market in Florida. Verizon faces serious competitive challenges from intra- and intermodal sources, and these challenges were considered in developing Verizon's economic lives.

Q. WHAT TECHNOLOGICAL INNOVATIONS WERE CONSIDERED IN YOUR ESTABLISHMENT OF VERIZON'S ECONOMIC LIVES?

A. Competitive carriers are utilizing not only their own facilities, such as switches, but also alternative technologies to provide telecommunications services that completely bypass the existing wireline network of the ILEC, such as wireless local loops and cable television lines. Prior to the passage of the 1996 Act, depreciation analysis consisted primarily of mortality analysis with only slight adjustments for technological change. Now, the rapid pace of advancement in technological innovations must be recognized in establishing the economic value of Verizon's assets.

Q. **WHAT OTHER GUIDES DOES VERIZON USE IN ESTABLISHING ASSET LIVES?**

A. To help quantify its professional judgment as to the appropriate lives for telephone plant, Verizon "benchmarks" (i.e., compares) its lives against those of its competitors, such as WorldCom, AT&T, and other cable television providers, and considers industry studies performed by Technology Futures, Inc. ("TFI").

Q. **PLEASE EXPLAIN WHY BENCHMARKING IS USEFUL AND APPROPRIATE.**

A. Benchmarking against competitors affords Verizon an excellent vehicle to assess the reasonableness of its recommended depreciation lives. As Verizon transitions to a competitive environment, it should be treated the same as its competitors with respect to setting depreciation rates. Competitors' depreciation rates are not reviewed or approved by any regulatory body, and are a good guide to reasonable practices in a competitive market.

Q. HAVE OTHER STATE COMMISSIONS USED SUCH BENCHMARKING TO ESTABLISH TELRIC RATES?

A. Yes. For example, the Missouri Public Service Commission compared Verizon's lives to the lives of the largest IXC, CATV, cellular, CAP, and PCS providers, and found that the depreciation lives for these companies were, in general, significantly shorter than Verizon's lives. The Missouri Commission concluded that "benchmarking GTE TELRIC rates against those booked for financial purposes of likely competitors and other companies using similar technologies is appropriate and is the best method to determine if GTE's TELRIC rates pass the muster of reasonableness."[27]

Q. HOW DO VERIZON ECONOMIC DEPRECIATION LIVES COMPARE WITH THOSE OF MCI AND AT&T?

A. Verizon lives are comparable to those used by AT&T & MCI. Specifically, Verizon used depreciation lives of 8 to 20 years (8 to 50 including Poles and Conduit) for communications and network equipment; 5 to 15 years for Other Equipment; and 33 years for buildings. In comparison, AT&T stated in its 2003 annual report, dated March 5, 2004, that depreciation is based on the asset's useful life,

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[27] Final Arbitration Order, *In the Matter Of AT&T Communications of the Southwest Inc.'s Petition for Arbitration Pursuant to Section 252(b) of the Telecommunications Act of 1996 to Establish an Interconnection Agreement between AT&T Communications of the Southwest, Inc. and GTE Midwest Inc.*, Case No. TO-97-63, Attachment C at 77 (Mo. P.S.C. July 31, 1997) ("*Missouri Order*").

which ranges from 3 to 15 years for communications and network equipment; 3 to 7 years for other equipment; and 10 to 40 years for buildings and improvements. MCI's 2003 annual report, dated April 27, 2004, also states that depreciation is based on the asset's estimated useful lives. For MCI, the useful life for Transmission Equipment is 4 to 30 years; 5 to 9 years for Telecommunications Equipment; and 4 to 39 years for Furniture, Fixtures, Buildings, and Other. MCI purports to give consideration to technological changes and trends when developing the lives, and to consider the views of internal and external outside experts.

Q. HOW DO THE LIVES USED BY THE CABLE TELEVISION ("CATV") OPERATORS COMPARE WITH THE LIVES USED BY VERIZON?

A. The lives used by CATV operators are shorter than Verizon's recommended lives. The lives adopted by the FCC for CATV distribution facilities were from 10 to 15 years.[28] This range was developed from a statistical analysis of lives used by CATV operators for their own facilities. Verizon, on the other hand, has recommended a 14- to 16-year economic life for copper cable and a 20-year life for fiber cable, which are longer than the range allowed by the FCC for CATV distribution facilities.

Likewise, the lives proposed by Verizon for support assets such as office furniture and equipment, vehicles, and buildings are reasonable

[28] Second Report and Order, First Order on Reconsideration, and Further Notice of Proposed Rulemaking, *In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation and Adoption of a Uniform Accounting System for Provision of Regulated Cable Service*, 11 FCC Rcd 2220 (1996).

when compared to the ranges allowed by the FCC for CATV operators. The FCC's range is 9 to 11 years for office furniture and equipment and 3 to 7 years for vehicles and equipment, as compared to Verizon's proposal of 5 to 15 years for these accounts. The FCC's range for buildings is 18 to 33 years, which shows that Verizon's proposal of 33 years for buildings is conservative.[29]

Q. WHAT IS TFI?

A. TFI is an independent research organization, unaffiliated with incumbent local exchange carriers, that specializes in conducting technology/market forecasts. TFI forecasts the remaining lives for certain telecommunications assets due to technological change and competition. To quantify the technological change, TFI uses a model to analyze remaining economic lives using patterns of technological substitution observed in the communications industry and other industries. To quantify the competitive change, TFI analyzes the impact of expected changes in customer demand on the economic value of the telecommunications assets. This change in economic value is then translated into a useful life impact. A 2001 TFI study forecasts that the local exchange network will continue to modernize and evolve, and that by 2015 only about 10% of the equipment in the local exchange network that was in place at the turn of the century will still be in use.[30]

[29] *See id.*

[30] Larry K. Vanston, Technology Futures Inc., The Local Exchange Network in 2015, Telecom & Technology Reports (2001) (reproduced at www.tfi.com).

Q. HOW DO THE LIVES THAT VERIZON USES IN THE UNE COST STUDIES COMPARE WITH TFI'S RECOMMENDED ECONOMIC LIFE RANGES?

A. The economic lives in Verizon's UNE cost studies fall within TFI's recommended economic life ranges, as shown by the following:[31]

	TFI Recommended	2003 VZ FL Cost Studies
Digital Switching	9-12	12
Digital Circuit	7-9	8
Metallic Cable	10-20	14-16
Non-Metallic Cable	15-20	20

VII. VERIZON'S ECONOMIC LIVES HAVE BEEN ENDORSED BY OTHER STATE REGULATORY COMMISSIONS.

Q. HAVE OTHER STATE COMMISSIONS ADOPTED THE DEPRECIATION LIVES RECOMMENDED BY VERIZON?

A. Yes. Although some state commissions have reached contrary conclusions, a number of states have adopted the GAAP depreciation lives recommended by Verizon. The Public Service Commission of the District of Columbia adopted Verizon's economic depreciation lives.[32]

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[31] Larry K. Vanston & Ray L. Hodges, Transforming The Local Exchange Network: Review And Update 5 (Technology Futures, Inc. 2003).

[32] Opinion and Order, *In the Matter of the Implementation of the District of Columbia Telecommunications Competition Act of 1996 and Implementation of the Telecommunications Act of 1996*, Formal Case No. 962, at ¶¶ 333-34 (D.C. Pub. Serv. Comm'n Dec. 6, 2002).

The D.C. Commission deemed these lives "TELRIC-compliant,"[33] and stated, "[b]ecause GAAP is more current than the FCC's depreciation lives, we deem GAAP more forward looking than the FCC's projection lives . . . ."[34] Similarly, the New York Public Service Commission rejected the FCC lives and adopted Verizon's depreciation recommendations, stating that "those shorter lives may well be appropriate for a TELRIC study," in that they better reflect the treatment of depreciation in the competitive market contemplated by TELRIC.[35] Commissions in Michigan and Missouri have also found that the financial reporting lives recommended by Verizon are the most appropriate for determining UNE rates.[36] In addition, the California Public Utilities Commission endorsed the use of the economic lives used by Verizon and Pacific Bell for external financial reporting purposes as the appropriate forward-looking lives for UNE cost studies, and correspondingly rejected the suggestion by AT&T and others that FCC-

[33] *Id.* ¶ 333.

[34] *Id.* ¶ 334.

[35] Decision and Order, *In re: Proceeding on Motion of the Commission to Examine New York Telephone Company's Rates for Unbundled Network Elements*, Case 98-C-1357, at 78 (N.Y.P.S.C. January 28, 2002).

[36] *Missouri Order*, Attachment C at 76; Opinion and Order, *In The Matter On The Commission's Own Motion To Consider The Total Service Long Run Incremental Costs And To Determine The Prices Of Unbundled Network Elements, Interconnection Services, Resold Services And Basic Local Exchange Services For GTE North,* Docket No. U-11281, at 28 (Mich. P.S.C. Feb. 25, 1998).

prescribed lives are forward-looking.[37] Moreover, the FCC approved of Verizon's economic depreciation lives in several § 271 proceedings.[38]

Q. HAVE ANY OTHER STATE COMMISSION DECISIONS RECENTLY ADOPTED GAAP LIVES?

A. Yes. In addition to the decisions cited above — several state commission decisions have recently selected GAAP lives over the FCC's prescribed lives to set UNE rates, a trend that, in the words of one commission, reflects "a more progressive view of depreciation."[39]

For example, the Illinois Commerce Commission adopted GAAP lives for purposes of determining UNE rates for SBC, finding that the FCC's lives were out-of-date and inconsistent with TELRIC.[40] The Illinois Commission stated that "the use of financial reporting lives [*i.e.*, GAAP

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[37] Rulemaking on the Commission's Own Motion to Govern Open Access to Bottleneck Services and Establish a Framework for Network Architecture Development of Dominant Carrier Networks and Investigation on the Commission's Own Motion into Open Access and Network Architecture Development of Dominant Carrier Networks, Rulemaking No. 93-04-003 and Investigation No. 93-04-002, Interim Opinion Adopting in Part and Ordering Modifications to Round I and II Cost Studies Submitted by Pacific Bell and GTE California, Decision No. 96-08-021, at 77 (Cal. P.U.C. August 2, 1996).

[38] Memorandum Opinion and Order, *In the Matter of Joint Application by SBC Communications Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance for Provision of In-Region, InterLATA Services in Kansas and Oklahoma*, 16 FCC Rcd 6237, 6274 ¶ 76 (2001); Memorandum Opinion and Order, *In the Matter of Application of Verizon Pennsylvania, Inc., Verizon Long Distance, Verizon Enterprise Solutions, Verizon Global Networks Inc., and Verizon Select Services Inc. for Authorization to Provide In-Region, InterLATA Services in Pennsylvania*, 16 FCC Rcd 17,419, 17,453-60 ¶¶ 55-72 (2001).

[39] Order, *Commission Investigation and Generic Proceeding of Rates and Unbundled Network elements and Collocation for Indiana Bell Telephone Company, Inc. d/b/a SBC Indiana Pursuant to the Telecommunications Act of 1996 and Related Indiana Statutes*, Cause No. 42393, at 60 (Ind. Util. Reg. Comm'n Jan. 5, 2004) ("*SBC Indiana Order*").

[40] *Illinois Bell Telephone Company Filing to increase Unbundled Loop and Nonrecurring Rates, 2004 Ill. PUC LEXIS 339, at 77* (June 9, 2004).

lives] both reflects and encourages the use of new and efficient technologies, as well as investment in infrastructure."[41] It predicted that increasing competition would "shorten[] the useful economic life of SBC's equipment," a fact that "further solidifie[d] the Commission's conclusion to approve SBC's use of financial reporting lives."[42] The Illinois Commission concluded that "[t]he shorter lives proposed by SBC are more in tune with current and forward-looking conditions" and thus "are more in line with TELRIC principles."[43]

Correspondingly, the Illinois Commission rejected the proposal to use the FCC's prescribed lives, observing that "[t]he FCC's lives were adopted nine years ago and do not necessarily reflect the forward-looking impact to depreciation of the competitive market that TELRIC assumes."[44] It added that "since the FCC regulatory lives pre-date the 1996 Act and the [*Triennial Review Order*], they may no longer indicate risks associated with facilities-based competition."[45]

The Indiana Utility Regulatory Commission likewise approved the use of GAAP lives in UNE cost studies, stating that this approach "is more appropriate . . . in light of TELRIC and the overall goals of the 1996

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[41] *Id.*

[42] *Id.*

[43] *Id.*

[44] *Id.*

[45/] *Id.*

Act."[46] As the Indiana Commission explained, "[t]echnological advancement continues at a rapid pace, leading to faster obsolescence of all types of telecommunications equipment. If anything, the pace of technological advancements should only increase as unbundling and pricing determinations are brought more in line with the goals of the 1996 Act in the wake of the 1999 Biennial Order, the Triennial Review Order, and the TELRIC NPRM, and as the incentive for facilities-based investment and innovation increases."[47] The Indiana Commission found that using GAAP lives would provide an incentive to use these rapidly developing new technologies, stating, "[w]e want to encourage SBC Indiana to take advantage of and deploy technological advancements, and one way to do that is to allow it to use reasonable depreciation lives based on criteria [employed] for financial reporting purposes."[48] In addition, the Indiana Commission concluded that competition warranted the use of GAAP lives. Citing the FCC's *Triennial Review Order*, the Indiana Commission stated that "the increase in competition faced by [ILECs], both intermodal and intramodal, compels use of shorter depreciation lives."[49]

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[46] *SBC Indiana Order* at 60.

[47] *Id.*

[48] *Id.*

[49] *Id.* (citing *Triennial Review Order* ¶ 685).

Most recently, the California Public Utilities Commission re-affirmed its previous decision to use financial lives,[50] and the Michigan Public Service Commission again decided to use financial reporting lives.[51]

VIII. CONCLUSION.

Q. PLEASE SUMMARIZE YOUR DIRECT TESTIMONY.

A. The economic lives recommended by Verizon are properly based on a forward-looking approach. Verizon has used the same depreciation inputs used for financial reporting to shareholders and the same inputs filed with this Commission and approved for regulatory reporting purposes. Verizon's proposed depreciation inputs should be adopted for use in the UNE cost studies.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.

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[50] Order, Decision 04-09-063, September 23, 2004

[51] Order, Case No. U-13531, September 21, 2004

Comparison of Verizon Florida's Recommended GAAP Depreciation Lives
and Recommended Future Net Salvage Percents with the FPSC Orderec
Depreciation Lives and Future Net Salvage Percents in UNE Docket 990649B-TF

	Account		LIFE YEARS			FNS SALVAGE %	
Account	Description		FPSC UNE	Verizon		FPSC UNE	Verizon
2112	Motor Vehicles		8.0	8.0		16	15
2114	Special Purpose Vehicles		7.0	12.0		0	0
2115	Garage Work Equipment		12.0	12.0		0	0
2116	Other Work Equipment		15.0	12.0		0	0
2121	Buildings		45.0	33.0		0	0
2122	Furniture		15.0	15.0		10	0
2123.1	Office Support Equip.		11.5	8.0		5	0
2123.2	Company Comm Equip.		11.5	8.0		5	0
2124	Computers		4.5	5.0		2	0
2212	Digital Switching Equipment		13.0	11.0		0	0
2220	Operator Systems		10.0	10.0		0	0
2231	Radio Systems		9.0	5.0		(5)	0
2232	Circuit Equipment		8.0	8.0		0	2
2362	Other Terminal Equipment		6.0	8.0		5	0
2411	Poles		35.0	30.0		(55)	(70)
2421.1	Aerial Ca. - Metallic		18.0	14.0		(14)	(30)
2421.2	Aerial Ca. - Non-Metallic		20.0	20.0		(14)	(5)
2422.1	U.G. Cable - Metallic		23.0	15.0		(8)	(30)
2422.2	U.G. Cable - Non Metallic		20.0	20.0		(8)	(5)
2423.1	Buried Ca. - Metallic		18.0	16.0		(7)	(15)
2423.2	Buried Ca. - Non Metallic		20.0	20.0		(7)	(5)
2422.1	Submarine Ca. - Metallic		18.0	16.0		(5)	(5)
2424.2	Submarine Ca. - Non Metallic		20.0	20.0		(5)	(5)
2426.1	Intrabuilding Ca. - Metallic		20.0	15.0		(10)	(5)
2426.1	Intrabuilding Ca. - Non Metallic		20.0	20.0		(10)	(5)
2441	Conduit Systems		55.0	50.0		(10)	(15)