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BELLSOUTH TELECOMMUNICATIONS, INC.
REBUTTAL TESTIMONY OF G. DAVID CUNNINGHAM
BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION
DOCKETS NO. 960833-TP, 960846-TP, 960757-TP, 971140-TP
December 9, 1997

Q. PLEASE STATE YOUR NAME, ADDRESS AND POSITION WITH
BELLSOUTH TELECOMMUNICATIONS, INC. (HEREINAFTER
REFERRED TO AS "BELLSOUTH" OR "THE COMPANY").

A. My name is G. David Cunningham and my business address is 3535
Colonnade Parkway, Birmingham, Alabama 35243. My position is
Director in the Finance Department of BellSouth.

Q. PLEASE GIVE A BRIEF DESCRIPTION OF YOUR EDUCATIONAL
BACKGROUND AND BUSINESS EXPERIENCE IN THE
TELECOMMUNICATIONS INDUSTRY.

A. I graduated from Morehead State University, Morehead, Kentucky in
1971 with a Bachelor of Arts Degree in Economics. I was employed by
South Central Bell in 1972 and held various staff and line assignments
in the Kentucky Network Operations Department until mid-1983. In
July of 1983, I moved to Birmingham, Alabama with BellSouth
Services, Inc., holding positions in the Corporate Affairs Department
and later in the Regulatory Department. My current assignment

1 includes responsibility for Regulatory and Depreciation concerns within
2 the Finance organization.

3

4 Q. WHAT ARE YOUR CURRENT JOB DUTIES AND
5 RESPONSIBILITIES?

6

7 A. I am responsible for the preparation of depreciation studies for the nine
8 states comprising BellSouth to determine appropriate depreciation
9 parameters and depreciation rates for booking purposes and to meet
10 regulatory requirements as necessary.

11

12 Q. HAVE YOU PREVIOUSLY APPEARED IN REGULATORY
13 PROCEEDINGS REGARDING DEPRECIATION ISSUES?

14

15 A. Yes. I have testified, been deposed, and also participated in
16 workshops before various state commissions regarding depreciation. I
17 have served as BellSouth's chief representative on several occasions
18 in negotiations with the Federal Communications Commission (FCC)
19 and the various state commissions in depreciation prescription
20 meetings.

21

22 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

23

24 A. The purpose of my testimony in this proceeding is to respond to the
25 direct testimony of Michael J. Majoros, representing AT&T and MCI,

1 regarding the economic lives used in BellSouth's cost studies. My
2 testimony will demonstrate the appropriateness of the depreciation lives
3 developed by BellSouth's Depreciation organization and provided for
4 use in the cost studies.

5

6 Q. WHAT IS THE BASIS OF THE LIVES THAT MR. MAJOROS
7 RECOMMENDS FOR USE IN THE COST STUDIES?

8

9 A. Mr. Majoros recommends that the projection lives last prescribed by the
10 FCC in 1995 for booking depreciation expense on an interstate basis
11 be used in the Florida cost studies.

12

13 Q. DO YOU AGREE THAT THESE LIVES ARE APPROPRIATE FOR
14 THIS APPLICATION?

15

16 A. No, I do not.

17

18 Q. WHY ARE THE LIVES LAST PRESCRIBED BY THE FCC IN 1995
19 FOR INTERSTATE DEPRECIATION PURPOSES NOT
20 APPROPRIATE FOR USE IN THE BELLSOUTH COST STUDIES?

21

22 A. The lives last prescribed by the FCC in 1995 for interstate purposes,
23 particularly for the technology-sensitive accounts, are much too long.
24 They are based on the old regulatory paradigm in which plant lives
25 were artificially lengthened beyond their true economic lives so that the

1 investment in that plant would be recovered in smaller year-to-year
2 increments over longer periods of time. The assumption under this
3 paradigm was always that BellSouth was entitled to and would recover
4 all of its investments, but over a longer period of time, thus reducing the
5 amount the customer paid in the short term.

6

7 In today's competitive environment, however, the marketplace is not
8 likely to allow BellSouth to recover investment based on lives that are
9 inappropriately long. The rapid changes in technology, which
10 BellSouth must embrace in order to stay competitive, shorten asset
11 lives significantly beyond what the FCC has prescribed. BellSouth has
12 emphasized to the FCC that substantially more progress is needed in
13 moving to lives that adequately reflect the current pace of technology
14 and competitive changes.

15

16 Q. HAS THE FCC GIVEN ANY INDICATION THAT CHANGES MAY
17 NEED TO BE MADE TO ITS PRACTICES CONCERNING
18 DETERMINATION OF PLANT LIVES?

19

20 A. Yes. The FCC has acknowledged the need to examine its depreciation
21 practices in today's environment. On several occasions, including a
22 reference in the FCC's Notice of Proposed Rulemaking released
23 December 24, 1996, regarding Access Reform and other issues (FCC
24 Docket No. 96-488), the FCC has stated that it has plans to initiate a

25

1 separate proceeding to undertake a comprehensive review of its
2 depreciation rules.

3

4 Q. WHAT LIVES DOES BELL SOUTH CONSIDER TO BE APPROPRIATE
5 FOR USE IN THE COST STUDIES?

6

7 A. The asset lives that were developed and provided for use in the cost
8 studies are included in Exhibit GDC-1.

9

10 Q. WHAT IS THE SOURCE OF THE LIVES USED IN THE COST
11 STUDIES?

12

13 A. The source of the lives provided for use in the cost studies is the 1995
14 and 1996 BellSouth Depreciation Studies, attached to this testimony as
15 Exhibit GDC-2. The lives used in the cost studies were determined by
16 calculating a simple average of the proposed lives for the nine states
17 proposed in these two studies. Although this is not a depreciation
18 proceeding, the depreciation studies included as Exhibit GDC-2 are
19 being provided to demonstrate the appropriateness of the data.

20

21 BellSouth prepared the detailed depreciation studies in this exhibit,
22 analyzing the various asset accounts to determine appropriate
23 depreciation parameters for each account. The studies provide
24 explanations of methodology, data and analysis that support the asset

25

1 lives and other depreciation parameters that are presented in the
2 studies.

3

4 Q. PLEASE SUMMARIZE BELL SOUTH'S APPROACH IN DETERMINING
5 THE ASSET LIVES USED IN THE COST STUDIES.

6

7 A. As demonstrated in the attached depreciation studies, numerous
8 methods are utilized to determine the appropriate economic lives of the
9 different asset accounts. One factor used in determining the
10 appropriate lives of all accounts is an analysis of Company planning
11 data. This data is useful in assessing the near term portion of the life
12 cycles of most assets, and is particularly useful when the technology is
13 near the end of its life cycle.

14

15 A second factor used in assessing the life of an account is normal
16 mortality, i.e., wear and tear with usage, deterioration with age and
17 accidental removal, breakage, or damage. The technique used to
18 assess normal mortality is called Historical Mortality Analysis. For
19 some accounts, like poles, Company planning data and normal
20 mortality alone are the major considerations in determining the life. In
21 these cases, the Company does not expect that the future
22 characteristics of this type of plant will differ significantly from the past.

23

24 In cases where a newer technology is substituting for an established
25 embedded technology, use of Company planning data and the

1 Historical Mortality Analysis alone to assess the life will generally result
2 in an inappropriately long life. Over the long term, the substitution of a
3 new technology for the old is the primary force driving the displacement
4 of the old technology. Therefore, in the later stages of deployment, life
5 analysis techniques that take into account the technological substitution
6 must also be used. These technology-sensitive accounts (that is,
7 Digital Electronic Switching, Circuit-Digital, Circuit-Analog, Aerial
8 Metallic Cable, Underground Metallic Cable, Buried Metallic Cable)
9 comprise over 70% of BellSouth's total plant investment.

10

11 Q. MR. MAJOROS STATES THAT THE PROJECTION LIVES
12 PRESCRIBED BY THE FCC ARE FORWARD-LOOKING AND
13 APPROPRIATE FOR USE IN BELL SOUTH'S COST STUDIES. DO
14 YOU AGREE?

15

16 A. No, I do not. It is clear that forward-looking lives should be used for
17 depreciation purposes and for the cost studies. However, BellSouth
18 believes that the FCC has not properly assessed the impact of
19 technological evolution and increasing competition to determine
20 appropriate forward-looking lives. BellSouth's depreciation studies, as
21 demonstrated in Exhibit GDC-2, provide detailed analysis to support
22 forward-looking lives significantly below those prescribed by the FCC,
23 particularly for the technology-sensitive accounts.

24

25

1 In considering whether FCC prescribed lives are appropriately forward-
2 looking, it is of interest to examine Exhibit GDC-3, which compares the
3 lives used in BellSouth's cost studies for the major technology sensitive
4 accounts with the lives that the FCC prescribed in 1994 for AT&T, on
5 whose behalf Mr. Majoros is appearing in this proceeding. As shown in
6 this comparison, AT&T's depreciation life for Digital Electronic
7 Switching, for example, is 9.7 years. The life that BellSouth uses in its
8 cost studies for this account is 10 years. Mr. Majoros supports an
9 unrealistically long life of 16 years. The comparison in this exhibit
10 demonstrates that, for all the major technology sensitive accounts, the
11 lives used in BellSouth's cost studies are comparable or conservative
12 when compared to AT&T's lives.

13

14 Q. HOW DO THE ECONOMIC LIVES USED IN THE COST STUDIES
15 COMPARE TO THE PROJECTION LIVES USED TO DETERMINE
16 THE DEPRECIATION RATES THAT BELLSOUTH IS CURRENTLY
17 BOOKING IN FLORIDA FOR INTRASTATE DEPRECIATION
18 PURPOSES?

19

20 A. As shown in Exhibit GDC-4, the economic lives used in BellSouth's
21 cost studies are similar to the projection lives used to determine the
22 intrastate depreciation rates that BellSouth is currently booking. The
23 Florida PSC has historically been quite progressive in its determination
24 of appropriate asset lives for depreciation purposes.

25

1 Q. HOW DO YOU RESPOND TO MR. MAJOROS'S STATEMENT THAT
2 BELLSOUTH'S CURRENT INTRASTATE DEPRECIATION RATES
3 ARE BASED ON REMAINING LIVES, NOT PROJECTION LIVES, AND
4 THAT THESE RATES ARE INAPPROPRIATE FOR FORWARD-
5 LOOKING COST STUDIES?

6
7 A. While the Florida PSC has actually prescribed Average Remaining
8 Lives for depreciation rates calculations, corresponding Projection
9 Lives for each account can be determined. These projection lives are
10 shown in Exhibit GDC-4.

11
12 BellSouth agrees that depreciation rates used for booking purposes are
13 not appropriate to use in the cost studies. BellSouth's booked
14 depreciation rates include a component for the depreciation reserve,
15 that is, the accumulated depreciation. Including the reserve in the
16 calculation of depreciation rates adjusts for the level of past
17 depreciation expense on the embedded investment. In addition, the
18 depreciation rates used for booking purposes are calculated by
19 allocating the net book investment less anticipated future net salvage
20 over the average remaining life of the investment. The average
21 remaining life represents an estimate of the number of years, on
22 average, that the current investment in a given account will live.

23
24 The depreciation rates used in the cost studies do not include a
25 depreciation reserve component. Further, these rates are calculated

1 by allocating the investment less anticipated future net salvage over the
2 projection life, not average remaining life, of the assets. The projection
3 life represents the average life expectancy of new additions to plant.
4 Therefore, the depreciation rates used in the cost studies are not
5 impacted by past unrecovered investment. They are appropriate for
6 use in BellSouth's forward-looking cost studies.

7
8 Q. HOW DO THE ECONOMIC LIVES USED IN THE COST STUDIES
9 COMPARE TO THE LIVES USED TO DETERMINE THE
10 DEPRECIATION RATES THAT BELL SOUTH IS CURRENTLY
11 BOOKING IN FLORIDA FOR EXTERNAL REPORTING PURPOSES?

12
13 A. The economic lives used in the cost studies are generally consistent
14 with those used to determine the depreciation rates currently being
15 booked in Florida for external reporting purposes.

16
17 Q. IS THERE ANY MERIT TO A CONCERN RAISED IN OTHER
18 JURISDICTIONS THAT LIVES USED FOR EXTERNAL REPORTING
19 PURPOSES ARE INAPPROPRIATE FOR USE IN COST STUDIES
20 DUE TO THE "CONSERVATISM" PRINCIPLE OF GAAP?

21
22 A. No. The "conservatism" principle of GAAP does not determine
23 BellSouth's lives. BellSouth's economic lives, used for external
24 reporting purposes and in BellSouth's cost studies, are determined by
25 the approaches described earlier in this testimony and detailed in

1 Exhibit GDC-2. These lives are used to determine depreciation rates
2 that appropriately allocate the cost of BellSouth's assets over their
3 estimated useful lives in a systematic and rational manner.

4

5 Q. MR. MAJOROS FOCUSES ON HISTORICAL RETIREMENT
6 PATTERNS FOR SOME OF BELLSOUTH'S TECHNOLOGY
7 SENSITIVE ACCOUNTS, AND ATTEMPTS TO LINK LIFE
8 PROJECTIONS TO THIS INFORMATION. WHAT COMMENTS DO
9 YOU HAVE REGARDING THIS APPROACH?

10

11 A. BellSouth does not believe that simply looking at the past can possibly
12 indicate what will happen in the future with equipment that is sensitive
13 to rapid changes in technology. This rear-view mirror approach is
14 clearly not appropriate for projecting the future of this equipment.
15 Emphasis on historical retirement patterns is an indication that one
16 expects the future not to vary significantly from the past. Even a casual
17 observance of the telecommunications industry today leaves no doubt
18 that there is an evolution taking place that cannot help but have a major
19 effect on telecommunications assets.

20

21 Retirements, particularly for the technology sensitive accounts, lag well
22 behind the decline in economic value of the assets. Experience with
23 technologies that have been displaced in the past, such as Step-by-
24 Step and Crossbar Switching, shows that the bulk of retirements are
25 most often concentrated at the end of the life span of a technology.

1 These retirements are not captured for the technologies that are
2 currently being displaced by simply focusing on historical retirement
3 rates. Life estimates based on these past retirement patterns are much
4 too long for these accounts. The lives used in the Florida cost studies
5 result from BellSouth's analysis of how future events will impact these
6 asset lives.

7

8 Q. MR. MAJOROS POINTS TO AN INCREASE IN THE DEPRECIATION
9 RESERVE OVER TIME AS EVIDENCE THAT FCC-PRESCRIBED
10 LIVES HAVE BEEN FORWARD-LOOKING. HOW DO YOU
11 RESPOND TO HIS STATEMENTS?

12

13 A. The fact that the reserve has grown over time is not an indication that
14 the reserve is at the appropriate level. The depreciation reserve is the
15 accumulation of all past depreciation accruals, reduced by plant
16 retirements. In an environment in which one technology is rapidly
17 displacing another technology, it is obvious that the depreciation
18 reserve must be built up by appropriate accruals to a level high enough
19 to handle the inevitable asset retirements. Today, we have two
20 situations in which a major technology displacement is occurring,
21 specifically, *digital is replacing analog and fiber is replacing copper.*
22 Never in the history of this industry has technology displacement been
23 so pronounced. Huge retirements of these old technologies are
24 *expected in bulk at the end of the technologies' life span.* Depreciation
25 accruals over the years have not been high enough, due to

1 inappropriately long prescribed lives for copper and analog related
2 assets, to position the depreciation reserve for the avalanche of
3 retirements that will soon come.

4
5 Mr. Majoros contends that a rising reserve percent indicates that the
6 depreciation process is working well. It is obvious that the critical issue
7 here is not just that the reserve has increased over the past few
8 decades. The issue is whether the reserve has increased enough to
9 handle retirements caused by the dramatic paradigm shift that has
10 occurred in the telecommunications industry.

11

12 Q. HOW DOES ONE DETERMINE WHAT THE APPROPRIATE
13 DEPRECIATION RESERVE LEVEL SHOULD BE AT A PARTICULAR
14 POINT IN TIME?

15

16 A. BellSouth uses the theoretical reserve requirement for this purpose.
17 The theoretical reserve requirement determines in theory what the book
18 reserve level should be at any point of an asset account's life. For
19 example, if the investment has lived 55% of its expected life, the book
20 reserve level should be 55%. If the book reserve is less than the
21 theoretical reserve requirement, then a reserve deficiency may exist.

22

23 Q. DOES BELLSOUTH CURRENTLY HAVE A RESERVE DEFICIENCY
24 ON AN FCC BASIS?

25

1 A. Yes. In BellSouth's Comments filed in the FCC Access Reform
2 proceeding (Docket No. 96-262), BellSouth estimated its theoretical
3 reserve requirement at 1/1/97 to be 54.6%, and its book reserve to be
4 only 48.6%. This results in a \$2.6B reserve deficiency in total for
5 BellSouth.

6
7 Q. HAS THE FCC EVER ACKNOWLEDGED THAT BELLSOUTH HAD A
8 RESERVE DEFICIENCY?

9
10 A. Yes. In the late 1980s, the FCC ordered a large reserve deficiency
11 amortization for the local exchange carriers for which it prescribed
12 depreciation rates. This occurred even though the FCC had made
13 some positive changes to its depreciation practices in the 1980s, such
14 as allowing Equal Life Group methodology and the Remaining Life
15 Depreciation Rate formula. Results of these changes did not indicate,
16 as Mr. Majoros states in his testimony on page 6, "that the FCC's
17 projection life estimates have been forward-looking and unbiased."
18 Rather it shows that asset lives had been so inappropriately long that a
19 large reserve deficiency existed despite changes in depreciation
20 methodology.

21
22 Q. WHAT SPECIFIC ACTION HAS BELLSOUTH TAKEN THAT
23 INDICATES THAT THE FCC PRESCRIBED LIVES HAVE BEEN
24 INADEQUATE?

25

1 A. The most dramatic indication of the inadequacy of prescribed asset
2 lives was demonstrated by the action taken when BellSouth
3 discontinued use of the regulated Financial Accounting Standard (FAS)
4 71 in favor of the nonregulated FAS 101 in 1995. The Company's
5 obligation to show the true value of its assets caused BellSouth to write
6 up the depreciation reserve by approximately \$4.9B for financial
7 reporting purposes. Much of this increase was due to inappropriately
8 long asset lives as prescribed by the FCC.

9

10 Q. MR. MAJOROS REFERENCES A STREAMLINED DEPRECIATION
11 RATE-SETTING PROCESS DEVELOPED BY THE FCC. HE GOES
12 SO FAR AS TO SAY THAT THE STREAMLINED APPROACH
13 ASSURES THE DEVELOPMENT OF FORWARD-LOOKING LIVES.
14 WHAT EXACTLY IS THIS STREAMLINED PROCESS AND WHAT IS
15 ITS PURPOSE?

16

17 A. As part of CC Docket No. 92-296, the FCC issued a Notice of Proposed
18 Rulemaking in which it stated that it was continuing its "efforts to reduce
19 unnecessary regulatory burdens and their associated costs by
20 undertaking simplification of our depreciation prescription process."
21 The FCC's approach to simplification was to set up ranges of projection
22 life and future net salvage estimates for most of the asset accounts.
23 Under this procedure, if a company meeting certain predetermined
24 criteria proposes to use projection lives or future net salvage estimates
25 from within these ranges, the company need not submit the

1 voluminous, detailed supporting data otherwise required. Thus, the
2 main purpose of this simplification effort was merely to lessen
3 paperwork and the cost of unnecessary regulation. Simplification was
4 not designed to assure forward-looking lives.

5

6 Q. WHAT WAS THE BASIS FOR THE PROJECTION LIVES AND
7 FUTURE NET SALVAGE PERCENTAGES THAT WERE USED TO
8 ESTABLISH THESE FCC RANGES?

9

10 A. The FCC's ranges were generally developed by nothing more than
11 taking one standard deviation around the mean of the lives and salvage
12 values that the FCC had prescribed most recently for the various
13 accounts for the local exchange carriers. For the first set of accounts
14 for which the FCC ordered ranges, the ranges were based on 1990-
15 1992 *represcriptions*, and have not been updated since. Lives
16 prescribed in 1990-1992 could hardly be considered forward-looking
17 today.

18

19 Q. SOME CONCERN HAS BEEN EXPRESSED IN OTHER
20 JURISDICTIONS AS TO THE APPROPRIATENESS OF THE LIVES
21 USED IN BELLSOUTH'S COST STUDIES FOR A NARROWBAND
22 NETWORK. DO YOU HAVE COMMENTS REGARDING THESE
23 CONCERNS?

24

25

1 A. Yes. The lives used in BellSouth's cost studies are based on the
2 economics of providing traditional telecommunications services, and
3 would be appropriate even if the only services BellSouth ever provided
4 in the future were narrowband, traditional telephony services. Our
5 existing network can be described as narrowband, and fiber
6 deployment in the feeder is already at a significant penetration level.
7 This is due to the advantages of fiber's high capacity, low maintenance
8 and reliability. Deployment of fiber in the distribution will also be driven
9 by these advantages. Fiber deployment in the feeder is greater than
10 that in the distribution because traffic in the feeder can be aggregated
11 and carried more efficiently in larger "pipes". Increasingly, the
12 economics of fiber deployment make it desirable further and further out
13 in the network (closer and closer to customer premises).

14
15 It should be pointed out that many customers use modems that operate
16 at 28,800 bits per second (bps) and greater over our narrowband, voice
17 grade network. Data transmission at these rates meet the current
18 needs of most residential customers. However, customer needs are
19 expanding, and BellSouth is designing today's network to meet
20 customers' growing needs. Today's customers are requesting services
21 that require higher bandwidth, but this is a long way from broadband,
22 cable TV capability. Replacement of today's network will occur due to
23 normal mortality and technological obsolescence, that is, when the
24 current technology is not the most efficient means of providing
25 narrowband service in the future.

1

2 Two other characteristics of fiber which are closely related are reliability
3 and maintainability. Customer needs for reliability, which are
4 increasing, can be met through the use of fiber in our network.
5 Maintenance expense, which the Company is always seeking ways to
6 reduce, can also be improved through the use of fiber. Both factors
7 add to the economic attractiveness of fiber for a narrowband, voice
8 grade network.

9

10 As stated above, the lives used in BellSouth's cost studies are based
11 on the economics of providing traditional telecommunications services.
12 They do not include future demands for emerging digital and
13 multimedia services, nor do they include the impact of a paradigm shift
14 to a totally competitive marketplace. Including these impacts would
15 likely result in a reduction of lives below the Company's current
16 recommendations.

17

18 Q. ARE THE LIVES USED IN BELLSOUTH'S COST STUDIES SPECIFIC
19 TO FLORIDA?

20

21 A. BellSouth regional lives are used in the cost studies, but BellSouth's life
22 projections do not vary significantly among states. As can be seen in
23 BellSouth's 1995 and 1996 Depreciation Studies included as Exhibit
24 GDC-2, BellSouth's lives for the major technology-sensitive accounts
25 are the same in all nine BellSouth states. In addition, in BellSouth's

1 most recent represcription by the FCC (that is, prescription of asset
2 lives for the states of Florida, Georgia, North Carolina and South
3 Carolina in 1995), the FCC prescribed projection lives that were
4 identical among these four states for 18 of the 29 accounts that it
5 prescribed, including large technology accounts such as Aerial and
6 Buried Metallic Cable, all Circuit equipment, and General Purpose
7 Computers. The FCC never expressed concern that these lives were
8 the same for all states.

9

10 Q. PLEASE SUMMARIZE YOUR TESTIMONY.

11

12 A. BellSouth's Depreciation organization has provided economic lives for
13 use in the cost studies, that were developed by performing detailed
14 analyses of each asset account. The BellSouth Depreciation Studies,
15 which document this analysis, are attached to this testimony as Exhibit
16 GDC-2. These lives are appropriate for use in BellSouth's cost studies.
17 Lives prescribed by the FCC for depreciation purposes are
18 inappropriately long, particularly for the technology-sensitive accounts.

19

20 Q. DOES THIS CONCLUDE YOUR TESTIMONY?

21

22 A. Yes, it does.

23

24

25