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January 25, 2005

Ms. Blanca S. Bayo, Director
Division of the Commission Clerk
and Administrative Services
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, FL 32399-0850

Re: Docket No. 050059-TL
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*

Dear Ms. Bayo:

Please find enclosed for filing an original and 15 copies of Verizon Florida Inc.'s Petition to Reform Its UNE Cost of Capital and Depreciation Inputs to Comply with the FCC's Guidance in *Triennial Review Order*. Also enclosed are an original and 15 copies of the Direct Testimonies of Anthony J. Flesch and James H. Vander Weide. Service has been made as indicated on the Certificate of Service. If there are any questions concerning this filing, please contact me at 813-483-1256.

Sincerely,

Richard A. Chapkis RW

Richard A. Chapkis

RAC:tas
Enclosures

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that copies of Verizon Florida Inc.'s Petition to Reform Its UNE Cost of Capital and Depreciation Inputs to Comply with the FCC's Guidance in *Triennial Review Order* and the Direct Testimonies of Anthony J. Flesch and James H. Vander Weide were hand-delivered on January 25, 2005 to:

Staff Counsel
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, FL 32399-0850

Richard A. Chapkis
Richard A. Chapkis

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. Filed: January 25, 2005

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*

Pursuant to Rules 25-22.036 and 28-106.201, Florida Administrative Code, Verizon Florida Inc. (Verizon) submits this petition to reform its unbundled network element (UNE) cost of capital and depreciation inputs to comply with the Federal Communications Commission's (FCC's) *Triennial Review Order.*[1]

I. INTRODUCTION

Verizon's UNE rates, which were established by the Florida Public Service Commission (Commission) in November 2002,[2] are unlawful because they violate the FCC's *Triennial Review Order* prescriptions regarding cost of capital and depreciation inputs for setting UNE rates. The Commission must modify these two model inputs so that Verizon's UNE rates comply with the FCC's total element long-run incremental cost (TELRIC) standard as outlined in the *Triennial Review Order.* Accordingly, Verizon respectfully requests that the Commission commence an expedited proceeding to

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[1] *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, Federal Communications Commission, CC Docket Nos. 01-338, 96-98, 98-147 (rel. Aug. 21, 2003) (*Triennial Review Order*).

[2] Verizon's UNE rates were set in Docket No. 990649B-TP by Order No. PSC-02-1574-FOF-TP, issued on November 15, 2002 (Verizon UNE Order).

reform these inputs based upon the forward-looking and TELRIC-complaint proposals of Verizon witnesses Dr. James H. Vander Weide and Mr. Anthony J. Flesch.[3]

II. THE COST OF CAPITAL AND DEPRECIATION INPUTS EMBEDDED IN VERIZON'S EXISTING UNE RATES ARE UNLAWFUL AND MUST BE REFORMED.

As discussed in detail below, the cost of capital and depreciation input assumptions underlying Verizon's existing UNE rates are inconsistent with the clarification articulated in the *Triennial Review Order*, and therefore must be reformed.

A. Overview of the *Triennial Review Order*

In the *Triennial Review Order*, which was issued on August 21, 2003, the FCC re-evaluated the market-opening requirements of the Telecommunications Act of 1996[4] in light of direction received from the federal courts, the FCC's own experience, and the experience of the telecommunications industry under the 1996 Act.[5] Among other things, the FCC expressly clarified the standards that state commissions must apply – and should have applied in the past – to determine the appropriate cost of capital and depreciation input assumptions when setting UNE rates under the FCC's TELRIC pricing scheme.[6]

With respect to cost of capital, the FCC clarified that the "risk-adjusted cost of capital used in calculating UNE prices should reflect the risks associated with a competitive market."[7] Specifically, the FCC ruled that a proper TELRIC-based cost of

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[3] The testimonies of Dr. Vander Weide and Mr. Flesch were filed concurrently with this petition.

[4] P.L. 104-104, 11`0 Stat. 56 (1996) (codified in various section of 47 U.S.C. §§ 151 *et seq.*) (1996 Act).

[5] *Triennial Review Order* at ¶¶ 1–3.

[6] *Id.* at ¶ 7 (Executive Summary, p. 14).

[7] *Id.* at ¶ 7 (Executive Summary, p. 14).

capital should reflect the risks of operating in a market characterized by facilities-based competition, and rejected the argument that the states should consider only the actual competitive risks the incumbent faces in providing UNEs.[8] Moreover, the FCC ruled that cost of capital for TELRIC should reflect the risks of the TELRIC standard itself:

> To calculate rates based on an assumption of a forward-looking network that uses the most efficient technology (*i.e.*, the network that would be deployed in a competitive market), without also compensating for the risks associated with investment in such a network, would reduce artificially the value of the incumbent LEC network and send improper pricing signals to competitors.[9]

In other words, as Dr. Vander Weide explains, the cost of capital input must reflect not only the risks of markets with facilities-based competitors, it must also take into account the risks of reconstructing the local exchange network with the most efficient technology in an environment where CLECs may cancel their UNE "leases" at any time, and the Commission may reset rates to reflect the allegedly lower costs of new technology before Verizon has recovered its initial investment in the network.[10]

With respect to depreciation, the FCC confirmed that its TELRIC methodology requires that UNE depreciation inputs "reflect any factors that would cause a decline in asset values, such as *competition and advances in technology*."[11] The FCC clarified that in "calculating depreciation expense, therefore, the rate of depreciation over the useful life should reflect the actual decline in value that would be anticipated in the

[8] *Id.* at ¶ 681.

[9] *Id.* at ¶ 682.

[10] Vander Weide Direct Testimony at 9:11–10:13; 37:10–58:12.

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

competitive market TELRIC assumes."[12] Moreover, the FCC made clear that the various components of TELRIC rates, including the depreciation inputs, 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 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.[13]

Thus, under TELRIC, depreciation lives – like the cost of capital inputs – must reflect forward-looking, fully competitive markets in which Verizon faces the real risk of losing customers to facilities-based competitors.[14]

B. The Cost of Capital Input Used To Set Verizon's UNE Rates Is Unlawful Because It Does Not Conform to the Requirements of the *Triennial Review Order.*

In Verizon's UNE case, the Commission based its 9.63 percent cost of capital input on Staff's testimony.[15] As Dr. Vander Weide explains, Staff's cost of capital calculation violated the forward-looking principles outlined in the *Triennial Review Order* because it did not account for the risks of reconstructing the network using the most efficient technology under the TELRIC standard. Specifically, Staff's cost of capital calculation did not reflect the risks of constructing a forward-looking network using the most efficient technology when CLECs have the option to cancel the lease at any time, and the Commission has the option to reset rates to reflect the allegedly lower costs of

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[12] *Id.* at ¶ 689 (emphasis added).

[13] *Id.* at ¶ 680 (emphasis added); *see also id.* at 689.

[14] *Id.* at ¶¶ 680, 685, 689.

[15] Verizon UNE Order at 87.

new technology before the ILEC has recovered its initial investment in the network. Indeed, Staff did not mention – let alone account for – these risks.[16] This omission is not surprising given that Staff's testimony was filed in January 2002 – more than a year and a half before the FCC issued the *Triennial Review Order*.[17] Accordingly, the cost of capital input adopted by the Commission in Verizon's UNE proceeding is inconsistent with the *Triennial Review Order*, and the Commission should thus adopt the TELRIC-compliant input recommended by Dr. Vander Weide.

C. The Depreciation Inputs Used To Set Verizon's UNE Rates Are Unlawful Because They Do Not Conform to the Requirements of the *Triennial Review Order*.

In Verizon's UNE rate-setting case, Verizon proposed to use the same depreciation lives it actually used for financial reporting purposes. The witness for the CLECs recommended use of the depreciation factors the FCC had prescribed in 1995. As an alternative, if the Commission were inclined to reject his primary recommendation, the CLEC witness advised the Commission to use the depreciation rates the Commission set for BellSouth in its UNE case. Ultimately, the Commission approved BellSouth's depreciation rates for Verizon, even though the Commissioners expressed considerable concern about the absence of record evidence to support use of BellSouth's depreciation lives for Verizon.[18]

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[16] Vander Weide Direct Testimony at 19:4–24:11.

[17] The FCC noted in the Virginia Arbitration Order that AT&T's and MCI's internal costs of capital exceed 15 percent, and in response to data requests in other proceedings, AT&T itself indicated that it currently uses a cost of capital for network investment decisions that is significantly higher than 15 percent. The fact that these CLECs' cost of capital exceeds 9.63 percent by a wide margin confirms that Staff's calculation does not reflect the risks of operating under the TELRIC standard. Vander Weide Direct Testimony at 25:1–22.

[18] Verizon UNE Order at 75.

Because the Commission simply applied BellSouth's depreciation inputs to Verizon, there was no attempt to assure that those inputs reflect the competitive challenges *Verizon* currently faces. Moreover, even if the Commission were to ignore this obvious shortcoming, the inputs adopted by the Commission are inconsistent with the *Triennial Review Order's* forward-looking principles. The BellSouth depreciation lives that were applied to Verizon are an amalgam of outdated depreciation lives recommended by BellSouth and CLECs.[19] In the BellSouth UNE rate 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."[20] BellSouth's witness explained that his recommendations are derived from BellSouth's 2000 Florida depreciation study.[21] Given that AT&T/WorldCom's recommendations are consistent with nine-year old depreciation lives established *before the* passage of the 1996 Act, these lives cannot reflect the principles of TELRIC and the effects of a fully competitive telecommunications market. Likewise, depreciation lives based on a 2000 study – now more than four years old – do not reflect the impact of future competition and technological change likely to occur in the fully competitive market that TELRIC assumes. Accordingly, in the wake of the forward-looking pronouncements in the *Triennial Review Order*, it is time to revise the depreciation input assumptions used to establish Verizon's UNE rates.

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[19] BellSouth's UNE rates were set 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 170–173.

[20] *See BellSouth UNE Order* at 158.

[21] *Id.* at 157.

III. THE COST OF CAPITAL INPUT PROPOSED BY VERIZON IS REASONABLE, CONSISTENT WITH THE *TRIENNIAL REVIEW ORDER*, AND SHOULD BE ADOPTED BY THE COMMISSION.

As discussed below, Verizon's proposed risk-adjusted cost of capital of 14.19% is reasonable and fully consistent with the forward-looking economic costing principles established by the FCC, and therefore should be adopted by the Commission.

A. Overview of Verizon's Cost of Capital Calculation

Verizon developed its cost of capital recommendation in two steps.

First, Verizon calculated the forward-looking economic cost of capital for a company operating in a competitive market. This calculation is a weighted average of the cost of debt and cost of equity. Verizon recommends a market capital structure containing 25 percent debt and 75 percent equity, a cost of debt of 6.15 percent, and a cost of equity of 13.46 percent. This produces a forward-looking cost of capital of 11.64 percent (25% x 6.15% + 75% x 13.46% = 11.64%).[22]

Second, Verizon calculated the risk premium required to compensate it for the risk of providing UNEs under the TELRIC standard. To allow Verizon an opportunity to earn 11.64 percent while providing UNEs under the TELRIC standard, it is necessary to add a risk premium to the weighted average cost of capital of 11.64 percent. Verizon's analysis, which applied option pricing formulas typically utilized in financial markets, shows that the incremental risk premium required to provide Verizon an opportunity to earn 11.64 percent is 2.56 percent. Accordingly, the TELRIC-compliant cost of capital input for use in UNE cost studies should be 14.19 percent (11.64% + 2.56% = 14.20% [difference due to rounding]).[23]

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[22] Vander Weide Direct Testimony at 58:14–67:14.

[23] *Id.* at 67:15–86:5.

B. Verizon's Proposed Cost of Debt Is Consistent with the FCC's TELRIC Standard.

Verizon obtained its market-based cost of debt from the 6.15 percent average yield to maturity on Moody's A-rated industrial bonds for April 2004, as reported in the Mergent Bond Record.[24] Verizon's approach is proper since the yield to maturity on A-rated industrial bonds best approximates the yield Verizon would actually pay on the debt issues it would normally use to finance the construction of a new telephone network. Indeed, it is conservative because it does not include the flotation costs that must be paid to issue the debt securities required to finance the building of local exchange facilities on a forward-looking basis.[25]

C. Verizon's Proposed Cost of Equity Properly Accounts for the Risk of Providing UNEs in a Competitive Market.

Verizon's proposed cost of equity is consistent with the *Triennial Review Order's* mandate that the cost of capital input should assume the risks of a market with full facilities-based competition. To establish a proposed cost of equity, Verizon utilized as proxies a group of publicly-traded competitive industrial companies (the S&P Industrials), rather than a group of telecommunications holding companies.[26] The S&P Industrials are a reasonable (albeit conservative) proxy for Verizon's risk of providing unbundled network elements in a competitive market because they are a group of competitive firms whose composite risk is average.[27] Moreover, using the S&P Industrials as proxies is preferable to using the telecommunications holding companies

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[24] Vander Weide Direct Testimony at 62:8–14. The Mergent Bond Record is updated once each year, in May, using data through April, so these are the most recent available figures.

[25] *Id.*

[26] *Id.* at 10:4–13; 62:25–66:19.

[27] *Id.*

adopted as proxies in Verizon's last UNE case because the S&P Industrials are not experiencing the same degree of radical restructuring and technological change as telecommunications holding companies.[28]

Several other state commissions have used the S&P Industrials as a proxy for the risks of providing UNEs in a competitive market. For example, the Massachusetts Department of Telecommunications and Energy, recognizing that the TELRIC standard required a proxy group of competitive companies in its UNE proceedings, chose the S&P Industrials as the most appropriate proxy.[29] The Pennsylvania Public Utilities Commission recently reviewed the cost of capital input in UNE cost studies to determine whether it was compliant with the FCC's guidance in the *Triennial Review Order.* It determined that its previous cost of capital input was not compliant, and revised its UNE cost of capital based on an S&P Industrial proxy group.[30]

In light of the foregoing, this Commission should adopt Verizon's proposed cost of equity.

D. Verizon's Market Value Capital Structure Is Forward-looking and Contains a Reasonable Proportion of Equity.

To estimate the competitive market cost of capital applicable to Verizon's UNE leasing operations, Verizon first determined the proper capital structure; that is, the

[28] *Id.*

[29] *I/M/O Investigation by the Department of Telecommunications and Energy on its own Motion into the Appropriate Pricing, Based on Total Element Long-Run Incremental Costs, for Unbundled Network Elements and Combinations of Unbundled Network Elements, and the Appropriate Avoided-Cost Discount for Verizon New England Inc. d/b/a Verizon Massachusetts' Resale Service in the Commonwealth of Massachusetts,* Massachusetts Department of Telecommunications and Energy Docket No. DTE 01-20, Order at 78-79 (July 11, 2002).

[30] *Generic Investigation Re Verizon Pennsylvania Inc.'s Unbundled Network Element Rates*, Dkt. R-00016683, Final Opinion and Order, Public Version at 61-62 (Pa P.U.C. Dec. 11, 2003). It bears mention that the Florida Staff itself recommended using a proxy group of industrial companies in its testimony in Verizon's collocation proceeding. *See* Rebuttal Testimony of Pete Lester, filed in FPSC Docket No. 981834, on April 18, 2003.

relative proportions of debt and equity to total capital. As Dr. Vander Weide made clear, a market value capital structure is the only capital structure consistent with the forward-looking economic cost principles adopted by the FCC. Market value capital structures are always forward-looking because investors look only to the future to determine the value of their stocks and bonds. Book value capital structures, by way of contrast, are based on arbitrary accounting conventions and the embedded or historical cost of the firm's assets, and are inherently backward-looking. For these reasons, economists unanimously reject the use of book value capital structures to estimate the weighted average cost of capital.[31]

Accordingly, Verizon examined market-based capital structure data for both the proxy group of S&P industrials and a group of telecommunications companies with incumbent local exchange subsidiaries. In examining the most currently available data for these companies, as well as data for the past five years, Verizon found that both groups on average have market value capital structures that contain 75 percent and, generally, substantially higher percentages of equity.[32] Verizon concluded that a 75 percent equity/25 percent total debt capital structure would be appropriate for Verizon; in fact, such a capital structure is conservative, given that the total debt ratio that Verizon uses includes both long-term and short-term debt. If short-term debt had been excluded from total capital, the percentage of debt in the capital structure of the proxy companies would have been even lower, and the percentage of equity would have been higher.[33]

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[31] Vander Weide Direct Testimony at 25:1–37:9.

[32] *Id.* at 59:19–60:16.

[33] *Id.* at 60:18–62:5.

E. Verizon's Proposed Cost of Equity and Weighted Average Cost of Capital Are Reasonable and Consistent with TELRIC and the *Triennial Review Order*.

To estimate the costs of equity, Verizon performed a discounted cash flow (DCF) analysis on the proxy group of publicly-traded S&P Industrials. This analysis resulted in a cost of equity of 13.46 percent.[34] Verizon determined its overall weighted average cost of capital, without considering the unique risks of the UNE regulatory and operating environment, to be 11.64 percent, based on a 6.15 percent market cost of debt, a target market value capital structure containing 25 percent debt and 75 percent equity, and a cost of equity of 13.46 percent.[35] As stated above, this analysis is conservative, because the S&P Industrials as a group underestimate the risks facing Verizon as a provider of UNEs.

While the proper method for determining risk and return for a provider of UNEs would be to estimate a cost of equity for publicly traded companies that only offer UNEs, there are no publicly-traded companies that have built telecommunications networks solely for the purpose of providing UNEs in a competitive market.[36] Thus, Verizon's DCF-derived weighted average cost of capital, without any additional premium to encompass the incremental risk posed by the UNE leasing business, understates the true cost of capital for Verizon as a provider of UNEs.

F. Verizon's Proposed Risk Premium Is Reasonable and Consistent with TELRIC and the *Triennial Review Order*.

In evaluating the risk of investing in the facilities required to provide UNEs, Verizon considered in detail the following five risks: (1) operating leverage; (2) demand

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[34] Vander Weide Direct Testimony at 66:16–19.

[35] *Id.* at 66:21–67:13.

[36] *Id.* at 63:14–17.

uncertainty; (3) rapidly changing technology; (4) the regulatory environment; and (5) lease cancellation.[37] In his testimony, Dr. Vander Weide explained that the degree of operating leverage required to provide facilities-based telecommunications services far exceeds the average degree of operating leverage required to provide the goods and services offered by the S&P Industrials. That is because the average industrial company is not as capital-intensive as Verizon and has a much lower investment in long-term fixed assets than does a provider of UNE services.[38]

In addition, Verizon operates under a regulatory regime that requires it to provide UNEs to its competitors at rates that very likely will not allow it to cover the cost of its investment in network facilities, including the cost of capital. As Dr. Vander Weide explains, the risk premium is necessary because the competitive market standard does not account for the additional risk Verizon faces for making long-term fixed investments in network facilities while its UNE customers have the option either to cancel their UNE leases, with no notice, and build their own facilities, or to renew their leases at lower rates when UNE rates are reset in a few years to reflect the lower cost of building a new telecommunications network using the most efficient available technologies.[39] Indeed, it is *that* risk that informs the *Triennial Review Order* clarification on setting cost of capital.

While each of the factors discussed above makes the risk of investing in the facilities required to provide UNEs greater than the risk of investing in the S&P Industrials, and while these risks are not quantified or accounted for in the DCF model, Verizon has not attempted to quantify fully the impact of every one of these risk factors

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[37] Dr. Vander Weide Direct Testimony at 10:4–13; 49:1–58:13.

[38] *Id.* at 64:9–14.

[39] *Id.* at 9:11–10:2; 69:4–71:6.

in its estimate of its cost of capital. Instead, Verizon has merely identified these differential risk factors to demonstrate that its base estimate of Verizon's cost of capital is conservative. However Verizon did specifically quantify one of the five aforementioned risk factors – namely, the differential risk arising from a CLEC's option to cancel its UNE lease contract. Specifically, Dr. Vander Weide estimated this required risk premium by:

(1) recognizing the difference between a non-cancelable financial lease and a cancelable operating lease;

(2) obtaining data from Verizon regarding the forward-looking investment and operating expense levels in the current UNE rates, and depreciation for the network required to provide UNEs in Florida;

(3) using a standard methodology for valuing a CLEC's option to cancel its lease one month at a time; and

(4) comparing the required rate of return on a financial lease for Verizon's network to the required rate of return on a cancelable operating lease for this network.[40]

The distinction between a non-cancelable financial lease and a cancelable operating lease is important because the typical UNE contract is, in fact, a cancelable operating lease, and Verizon's investment risk is significantly higher than it would be if UNE contracts approximated non-cancelable financial leases.[41] That is because Verizon's network investment is large, long-lived, and mostly sunk once the investment is made. If CLECs may either cancel their leases altogether or renew at lower rates

[40] Vander Weide Direct Testimony at 67:15–86:5.

[41] *Id.* at 69:4–24.

whenever new, lower-cost technologies become available, Verizon's revenues will decline, but its investment and operating expenses will remain the same.[42] Critically, these are risks inherent in the UNE environment, not technological or planning risks that an ordinary company could prevent or minimize through ordinary administration of its business.

IV. THE DEPRECIATION INPUTS PROPOSED BY VERIZON ARE REASONABLE, CONSISTENT WITH THE *TRIENNIAL REVIEW ORDER*, AND SHOULD BE ADOPTED BY THE COMMISSION.

As discussed below, Verizon's proposed depreciation inputs are reasonable, unbiased and fully consistent with the forward-looking economic costing principles established by the FCC, and therefore should be adopted by the Commission.

In this proceeding, Verizon is advocating that the Commission adopt the same forward-looking depreciation lives that it uses in its external financial reports filed with the Securities and Exchange Commission (SEC) and that it provides to its shareholders. These depreciation lives, which have been reviewed by external auditors and reported to the financial community, are inherently reliable and unbiased. As explained further below, these depreciation lives are also forward-looking – taking into account both the competition and advances in technology that must be included in proper TELRIC-based depreciation inputs.[43]

As a starting point for establishing its GAAP lives, Verizon used the factors prescribed in the NARUC Depreciation Manual for the retirement of assets.[44] In assessing these factors, Verizon appropriately referred to numerous sources, including

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[42] Vander Weide Direct Testimony at 70:1–12.

[43] Flesch Direct Testimony at 8:11–23. A complete list of Verizon's proposed depreciation lives and future net salvage percentages are set forth in Attachment A to the testimony of Mr. Flesch.

[44] *See* Flesch Direct Testimony at 21:1– 22:14.

its own internal capital spending and budgets, engineering plans concerning the retirement of equipment, and current and anticipated levels of facilities-based competition.

Verizon then applied a variety of industry benchmarks to ensure that its GAAP lives were reasonable.[45] Industry benchmarking provides an external validity check to confirm that the results obtained by Verizon's process used to assess depreciable lives are consistent with the lives obtained by competitors using similar technology and operating in similar competitive markets. For this industry benchmarking, Verizon compared its depreciable lives with the lives used by its competitors AT&T and MCI, depreciable lives used by cable television operators using similar technology in providing their services, and industry studies performed by Technology Futures, Inc. The analysis based on the mix of companies confirms that Verizon's GAAP lives are reasonable from both the competitive and technological standpoints that TELRIC requires.[46]

Verizon's adherence to GAAP is verified through its outside independent auditors. Those auditors, applying federal law, SEC regulations and their professional judgment, evaluated and confirmed that the Company's proposed depreciation lives conform with GAAP.[47]

Of course, Verizon's proposed depreciation inputs are subject to additional safeguards. First, the Financial Accounting Standards Board (FASB) requires that, to conform to GAAP, representations made in a company's financial statements reflecting

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[45] *Id.* at 23:10–27:13.

[46] *Id.*

[47] *Id.* at 8:11–23.

depreciation expense must be based on "evenhanded, neutral, or unbiased information."[48] Second, market forces provide an incentive for Verizon to report unbiased depreciation lives because the reporting of biased shorter depreciation lives produces higher expenses, lower net income, and lower asset values, all of which send negative signals to investors, which, in turn, lead to lower expectations and lower stock prices.[49] Unduly short depreciation lives also send negative signals to creditors, making it more difficult and expensive for a company to borrow and would negatively affect managers' compensation since a company's net income is an important factor in the consideration of management performance.[50] Third, under the Sarbanes-Oxley Act of 2002, both the Chief Executive Officer and the Chief Financial Officer of a company must certify that the company's financial statements, including depreciation expense, fairly present the financial condition and results of the company.[51]

Not only are Verizon's proposed depreciation lives reliable and unbiased, they are consistent with the principles of TELRIC. In establishing GAAP lives, Verizon considered the future decline in economic benefits produced by its assets due to factors such as entry of competition, technological change, and the physical wearing out of its assets, all factors consistent with GAAP. As Mr. Flesch explains, Verizon's proposed depreciation inputs are by their very nature, forward-looking:

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[48] *Id.* at 16:1–17:2.

[49] Flesch Direct Testimony at 18:13–19:25.

[50] *Id.*

[51] *Id.* 17:4–15.

> 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.[52]

A number of state commissions have adopted GAAP lives because they are consistent with the forward-looking TELRIC requirements. For example, the Public Service Commission of the District of Columbia adopted Verizon's economic depreciation lives.[53] The D.C. Commission deemed these lives "TELRIC-compliant,"[54] and stated, "Because GAAP is more current than the FCC's depreciation lives, we deem GAAP more forward looking than the FCC's projection lives . . . ."[55] 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.[56] Commissions in Michigan and Missouri

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[52] Flesch Direct Testimony at 9:12–19.

[53] 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).

[54] *Id.* ¶ 333.

[55] *Id.* ¶ 334.

[56] 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).

have also found that the financial reporting lives recommended by Verizon are the most appropriate for determining UNE rates.[57]

In light of the foregoing, the depreciation lives reflected in Verizon's financial statements, determined in accordance with GAAP, are the best available estimates of forward-looking lives in compliance with the FCC's TELRIC standard in the *Triennial Review Order*, and therefore should be adopted by this Commission.

V. CONCLUSION

The Commission should grant Verizon's petition to reform the cost of capital and depreciation input assumptions embedded in its existing unbundled network element rates.

Respectfully submitted on January 25, 2005.

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[57] *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).