State of Florida

Public Service Commission

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TALLAHASSEE, FLORIDA 32399-0850

-M-E-M-O-R-A-N-D-U-M-

DATE: June 9, 2005

TO: Director, Division of the Commission Clerk & Administrative Services (Bayó)

FROM: Division of Competitive Markets & Enforcement (Mailhot, Salak, P. Lee)
Division of Economic Regulation (Maurey)
Office of the General Counsel (Susac)

RE: Docket No. 050059-TL – Petition to reform unbundled network element (UNE) cost of capital and depreciation inputs to comply with Federal Communications Commission's guidance in Triennial Review Order, by Verizon Florida Inc.

AGENDA: 06/21/05 – Regular Agenda – Proposed Agency Action – Interested Persons May Participate

COMMISSIONERS ASSIGNED: All Commissioners

PREHEARING OFFICER: Deason

CRITICAL DATES: None

SPECIAL INSTRUCTIONS: None

FILE NAME AND LOCATION: S:\PSC\CMP\WP\050059.RCM.DOC

Case Background

Verizon's rates for unbundled network elements (UNE) were set by the Florida Public Service Commission (Commission) in Order No. PSC-02-1574-FOF-TP, issued November 15, 2002, in Docket No. 990649B-TP, In Re: Investigation into Pricing of Unbundled Network Elements (Sprint/Verizon Track). In December 2002, Verizon appealed the Commission's order to the Florida Supreme Court raising four issues: (1) whether the Commission's cost of capital allocations were supported by competent, substantial evidence; (2) whether the Commission's depreciation allocations were supported by competent, substantial evidence; (3) whether the Commission's adjustments to Verizon's loading factors were reasonable and supported by the record; and (4) whether certain other calculations made by the Commission were proper. On September 2, 2004, the Florida Supreme Court upheld the Commission's decision on all four issues.

On January 25, 2005, Verizon filed this petition to change the cost of capital and depreciation inputs that were approved and used in calculating Verizon's UNE rates.[1] Verizon is requesting a 14.19% cost of capital and the use of the same depreciation lives that it uses for external financial reporting purposes. In its petition, Verizon contends that "Verizon's UNE rates, which were established by the Commission in November 2002, are unlawful because they violate the FCC's *Triennial Review Order* prescriptions regarding cost of capital and depreciation inputs for setting UNE rates."

In the *Triennial Review Order* (TRO)[2], released August 21, 2003, the FCC clarified the standards that state commissions must apply when determining the appropriate cost of capital and depreciation input assumptions for setting unbundled network element (UNE) rates. In Issue 1, staff addresses the cost of capital. In Issue 2, staff addresses the depreciation inputs.

[1] Along with its petition, Verizon also filed testimony.
[2] FCC 03-36, released August 21, 2003, in CC Docket Nos. 01-338, 96-98, and 98-147, In the Matter of Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, and Deployment of Wireline Services Offering Advanced Telecommunications Capability, Report and Order and Order on Remand.

Discussion of Issues

Issue 1: Should the cost of capital inputs used to calculate Verizon's UNE rates be changed?

Recommendation: No. Verizon's cost of capital inputs should not be changed. (Salak, Mailhot, Maurey)

Staff Analysis: In the TRO, the FCC clarified two aspects of the determination of the appropriate cost of capital for purposes of Total Element Long-Run Incremental Cost (TELRIC) proceedings. First, the FCC stated that the cost of capital used in a TELRIC proceeding should be based on the same assumptions regarding technology and competition that are used to determine network investment. In other words, since TELRIC is intended to produce rates a firm would charge in a competitive market, the cost of capital should reflect the risk of losing customers to and gaining customers from other competitors. Second, the FCC clarified that the cost of capital in a TELRIC proceeding should reflect any unique risks associated with the potential for providing new services over various types of facilities. (FCC 03-36, ¶680-683)

The 9.63% cost of capital input used in calculating Verizon's UNE rates was approved by the Commission in Order No. PSC-02-1574-FOF-TP, issued November 15, 2002, in Docket No. 990649B-TP, In Re: Investigation into Pricing of Unbundled Network Elements (Sprint/Verizon Track). As noted in Verizon's petition, the witnesses' testimony, the Commission's consideration of the evidence, and the Commission's eventual decision in the case all occurred prior to the issuance of the FCC's TRO on August 21, 2003. Based upon its review of the record in Docket No. 990649B-TP and Order No. PSC-02-1574-FOF-TP, staff agrees with Verizon that the 9.63% cost of capital input does not technically comply with the TRO.

That said, it should be noted that the Commission has considered the cost of capital input for Verizon more recently than its November 2002 decision. In Order No. PSC-04-0895-FOF-TP, issued September 14, 2004, in Docket No. 981834-TP, In Re: Petition of Competitive Carriers for Commission Action to Support Local Competition in BellSouth Telecommunication, Inc.'s Service Territory and Docket No. 990321-TP, In Re: Petition of ACI Corp. d/b/a Accelerated Connections, Inc. for Generic Investigation to Ensure that BellSouth Telecommunications, Inc., Sprint-Florida, Inc., and GTE Florida, Inc. Comply with Obligation to Provide Alternative Local Exchange Carriers with Flexible, Timely, and Cost-Efficient Physical Collocation, the Commission approved a cost of capital of 9.80% for Verizon for the provision of collocation. In this decision, the Commission expressly stated in its Order that it considered the clarifications in the FCC's TRO in determining the cost of capital input for Verizon.

Since the 9.63% cost of capital currently embedded in Verizon's UNE rates is not TRO-compliant, an argument could be made that the Commission should approve Verizon's request to revise the cost of capital input for purposes of setting its UNE rates. If the Commission were so inclined, it could use the TRO-compliant 9.80% cost of capital recently approved in Order No. PSC-04-0895-FOF-TP for purposes of Verizon's petition. This would result in an estimated increase in UNE rates of approximately 2%. Staff estimates that Verizon's requested change in cost of capital inputs would increase UNE rates by over 30%.

However, based on the testimony of Verizon's own witness, the weighted average cost of capital for Verizon appears to have decreased since the Commission began its consideration of this issue. Witness Vander Weide recommended a weighted average cost of capital of 12.95% for purposes of the 2002 proceeding, 12.03% for purposes of the 2004 proceeding, and 11.64% in the instant docket. It should be noted that the above listed rates of return do not include witness Vander Weide's additional risk premium adjustment, which was specifically rejected by the Commission in Order No. PSC-04-0895-FOF-TP. Although the clarifications in the TRO would tend to put upward pressure on the resulting cost of capital, the overall level of capital costs have trended downward over this period, offsetting the impact of the TRO clarifications.

While the 9.63% cost of capital authorized in Order No. PSC-02-1574-FOF-TP was approved prior to the issuance of the FCC's TRO, staff believes the 9.80% cost of capital approved in Order No. PSC-04-0895-FOF-TP is clearly TRO-compliant. It is questionable whether the 9.80% cost of capital is significantly different from the 9.63% cost of capital to warrant the time and expense involved with resetting UNE rates as proposed by Verizon. Moreover, based on the testimony of Verizon's own witness, a strong case can be made that the cost of capital has decreased since the Commission approved the 9.80% return in September 2004 and therefore a current TRO-compliant cost of capital may be equal to or less than the 9.63% cost of capital already reflected in Verizon's UNE rates. For these reasons, staff believes no reform is needed to the cost of capital inputs used in determining existing UNE prices.

However, if the Commission finds merit in Verizon's petition, then Verizon should be directed to recalculate the UNE rates established in Order No. PSC-02-1574-FOF-TP, in accordance with the Commission's decision today, concerning the appropriate cost of capital, and provide both the recalculated UNE rates and the supporting documentation for those rates for staff's review. Staff will bring the recalculated rates to agenda for the Commission's consideration.

Issue 2: Should the depreciation inputs used to calculate Verizon's UNE rates be changed?

Recommendation: No. Verizon's depreciation inputs should not be changed. (Salak, Mailhot, P. Lee)

Staff Analysis: Depreciation is the mechanism by which the investment in an asset is recovered over the life of that asset. There are two components of depreciation – the useful life and net salvage of the asset, and the rate at which the asset is depreciated. As staff understands, Verizon's long-run incremental cost model (ICM-FL) uses capital cost factors to convert total element long-run incremental cost (TELRIC) investments into annual costs for unbundled network elements (UNEs). One of these computed capital cost factors, Depreciation and Return factor, utilizes user-adjustable data inputs related to rate of return and depreciation lives and salvage values for each investment.

The purpose of this proceeding is specifically to determine whether the depreciation lives and salvage values the Commission adopted for Verizon in its last UNE proceeding, Order No. PSC-02-1574-FOF-TP, issued November 15, 2002, in Docket No. 990649B-TP, In Re: Investigation into Pricing of Unbundled Network Elements (Sprint/Verizon Track) are compliant with the TRO clarification for depreciation. Verizon claims that the depreciation input assumptions underlying existing UNE rates are inconsistent with the TRO clarification and are therefore unlawful and must be reformed. Verizon asserts, in its petition and through its witness's testimony, that the depreciation lives Verizon uses for external financial reporting purposes are consistent with the forward-looking economic costing principles established by the FCC in the TRO and should be adopted for use in developing UNE prices. While Verizon did not provide the impact of its recommendations when it filed this petition, staff estimates that Verizon's depreciation recommendations would increase existing UNE rates by about 10%.

In the *Local Competition First Report and Order*[3], the FCC found that its prescribed asset lives and salvage values were a reasonable starting point for depreciation inputs in cost proxy models for determining UNE prices. The FCC also found that the incumbent local exchange companies (ILECs) bear the burden of demonstrating with specificity that different depreciation inputs should be used. Finally, the FCC concluded that a TELRIC-compliant depreciation rate should reflect changes in the economic value of an asset, a method described as economic depreciation.[4] The U.S. Supreme Court affirmed the TELRIC pricing methodology and upheld the FCC's prescription of lives and salvage values for developing the depreciation expense to be used in setting UNE prices.[5]

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[3] FCC 96-325, released August 8, 1996, CC Docket No. 96-98, In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, and CC Docket No. 95-185, In the Matter of Interconnection between Local Exchange Carriers and Commercial Mobile Radio Service Providers, First Report and Order (*Local Competition First Report and Order).*

[4] Ibid. ¶ 702-703. Economic depreciation is a method of reflecting anticipated declines in the net present value of an asset over the useful life of the asset. In theory, economic depreciation will result in expenses that vary from year to year.

[5] Verizon Communications Inc., et al. v. Federal Communications Commission, et al., 535 U.S. 467 (2002) (*Verizon v. FCC)*, pp. 48-52.

In the TRO, the FCC acknowledged that it had given scant guidance in the *Local Competition First Report and Order* with respect to the economic depreciation concept. The FCC expressly declined to mandate the use of financial lives in computing depreciation expense under TELRIC, although it raised concern regarding how to capture the rate of price decline associated with economic depreciation. It acknowledged, however, that such a consideration raised issues that had not been previously addressed, either by state commissions or the FCC.[6]

Verizon alleges in its petition that the depreciation input assumptions underlying the existing UNE rates approved by Order No. PSC-02-1574-FOF-TP do not reflect the competitive challenges it faces. Moreover, Verizon asserts, the inputs are inconsistent with the TRO's forward-looking principles because the lives are "an amalgam of outdated depreciation lives recommended by BellSouth and CLECs."

In Verizon's last UNE proceeding in Docket No. 990649B-TP, Verizon proposed use of its financial depreciation lives and salvage values in determining UNE prices. The Commission concluded in Order No. PSC-02-1574-FOF-TP that Verizon had not provided sufficient evidence to show that its proposed depreciation inputs (financial lives and salvage values) were appropriate for use in developing Verizon's UNE rates. Rather, the Commission adopted the same depreciation input values for Verizon as it had for BellSouth in Order No. PSC-01-1181-FOF-TP, issued May 25, 2001, in Docket No. 990649-TP, In Re: Investigation into Pricing of Unbundled Network Elements. The Commission's decision was founded on the assumption that similar plant exposed to similar factors of obsolescence such as technology, market competition, and physical wear and tear would exhibit similar depreciation lives and salvage values. While these depreciation inputs were approved prior to the issuance of the TRO, staff believes that these inputs are clearly TRO-compliant because they reflected the impacts of competition and technological advances.[7]

In the collocation proceeding, Docket No. 981834-TP, In Re: Petition of Competitive Carriers for Commission Action to Support Local Competition in BellSouth Telecommunication, Inc.'s Service Territory and Docket No. 990321-TP, In Re: Petition of ACI Corp. d/b/a Accelerated Connections, Inc. for Generic Investigation to Ensure that BellSouth Telecommunications, Inc., Sprint-Florida, Inc., and GTE Florida, Inc. Comply with Obligation to Provide Alternative Local Exchange Carriers with Flexible, Timely, and Cost-Efficient Physical Collocation, Verizon again proposed its financial depreciation lives and salvage values to use as inputs to determine collocation rates. In Order No. PSC-04-0895-FOF-TP, issued September 14, 2004, the Commission found that the depreciation inputs ordered for Verizon in Docket No. 990649B-TP were TELRIC-compliant and appropriate and reasonable to use for collocation. The Commission found an insufficient record to indicate a need to deviate from the inputs approved in Docket No. 990649B-TP, citing that there was no established basis for any change.

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[6] Among the questions needing to be addressed are: (1) how to measure the anticipated decline in the value of assets; (2) whether shorter asset lives represent an alternative method of capturing this decline; (3) how UNE prices should be structured to reflect decreases in depreciation expense from one period to the next; and (4) whether levelizing rates across periods, as most cost models do, diminishes or even eliminates the intended effect of the acceleration.

[7] Additionally, staff would note that the approved life values are generally shorter than the low end of the FCC-prescribed range of life values for the more technologically impacted accounts.

The testimony of Verizon's witnesses in the instant petition again advocates the use of financial reporting lives[8] in setting UNE rates, offering little more than what was submitted in the last UNE and collocation proceedings, which the Commission found to be insufficient. Verizon's recommended financial life inputs are generally shorter than those previously adopted by the Commission, especially for the metallic cable accounts. Verizon's testimony lacks any data or analyses showing specifically how its financial lives were developed. Staff notes that, contrary to Verizon, BellSouth and Sprint both perform data analyses in determining and supporting their depreciation life and salvage inputs for UNE and collocation rates.

Moreover, staff opines that Verizon's testimony is again devoid of any discussion or support for its proposed salvage values. Staff notes with curiosity that while Verizon advocates use of its financial lives, it does not appear to be advocating use of its financial salvage values. In its 10-Q financial report, Verizon states that it now expenses the cost of removal in excess of salvage as incurred, rather than accruing those costs through depreciation expense in accumulated depreciation.[9] Verizon's 10-Q does not specifically indicate the salvage values it uses for financial purposes, although staff surmises that for each account where Verizon's recommendation is a negative net salvage, for financial reporting purposes, the cost of removal would be expensed.

The FCC noted in its *TELRIC Pricing Notice of Proposed Rulemaking* (TELRIC NPRM)[10], released subsequent to the TRO, that calculating the rate of price decline associated with economic depreciation is quite complicated because it is based largely on projections of future events. The FCC recognized that this is even more difficult in UNE pricing cases because of the manner in which the cost models calculate prices. The TELRIC NPRM explained that the levelization function that currently exists in cost models imposes a constant price schedule over the life of the asset rather than varying prices that capture the rate of price decline. This, the FCC asserts, is counter intuitive to the concept of adjusting UNE prices to reflect anticipated equipment price changes.[11] The FCC is currently considering various approaches to reflecting anticipated equipment price changes in its TELRIC NPRM.

As discussed previously, the purpose of this proceeding is specifically to determine whether the depreciation lives and salvage values the Commission adopted for Verizon in its last

[8] Financial depreciation lives and salvage values are those a company reports in its external financial statements to its stockholders. These lives and salvage values are governed by Generally Accepted Accounting Principles (GAAP) and tend to be shorter than those the Commission has adopted for determining wholesale prices. Although the use of financial lives and salvage values has been considered by the FCC in previous rulemaking proceedings, the FCC continues to note, as it did in the TRO, that GAAP and other non-FCC regulatory safeguards are intended to protect investor interests, not ratepayer interests. For this reason, the FCC has not mandated the use of financial depreciation lives and salvage values for use in developing wholesale prices.

[9] According to statements in Verizon's 10-Q financial report, Verizon adopted Statement of Financial Accounting Standards (SFAS) No. 143, "Accounting for Asset Retirement Obligations" effective January 1, 2003. Verizon states the SFAS No. 143 requires it to exclude cost of removal from the design of its depreciation rates where removal costs exceed salvage.

[10] FCC 03-224, released September 15, 2003, WC Docket No. 03-173, In the Matter of Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers (*TELRIC Pricing Notice of Proposed Rulemaking).*

[11] Ibid. at ¶92, ¶¶ 102-106.

UNE proceeding in Order No. PSC-02-1574-FOF-TP, are compliant with the TRO clarification for depreciation. Based on the above discussion, staff believes the depreciation inputs in existing UNE rates are TRO-compliant. First, the depreciation inputs underlying existing UNE prices clearly reflected technology and market competition that even Verizon notes are required to be TELRIC and TRO-compliant. Second, the FCC expressly declined to require the use of financial lives in establishing depreciation expense under TELRIC in the TRO, noting there was no empirical evidence to conclude that financial lives are more consistent with TELRIC than regulatory lives.[12] Third, the TRO clarification clearly raises a concern that the pattern of expenses computed in cost models does not capture the expected rate of price decline of equipment prices. There is no TRO clarification with respect to depreciation life and salvage value inputs.[13]

<u>Conclusion</u>

For the above reasons, staff believes the adopted depreciation inputs used in determining existing UNE rates established in Order No. PSC-02-1574-FOF-TP do not violate the TRO clarification with respect to depreciation and are not unlawful. This is not to say, however, that currently adopted depreciation inputs may not need to be revised due to the passage of time or changed circumstances. Verizon simply has not provided specific data or analyses that supports the need for a revision.

However, if the Commission finds merit in Verizon's petition and adopts the use of financial lives as inputs for UNE rates, it should adopt the use of financial salvage values, rather than those filed in the petition. The Commission should direct Verizon to submit the salvage values, by account, that it uses for financial reporting purposes. Verizon should then be directed to recalculate the UNE rates established in Order No. PSC-02-1574-FOF-TP, in accordance with the Commission's decision today, concerning the appropriate depreciation lives and salvage values, and provide both the recalculated UNE rates and the supporting documentation for those rates for staff's review. Staff will bring the recalculated rates to agenda for the Commission's consideration.

[12] FCC 03-36 at ¶ 688.
[13] Ibid. at ¶¶ 689-690.

<u>Issue 3</u>: Should this docket be closed?

<u>Recommendation</u>: Yes. If no person whose substantial interests are affected by the proposed agency action files a protest within 21 days of the issuance of the order, this docket should be closed upon issuance of a consummating order. (Susac)

<u>Staff Analysis</u>: If no protest is filed by the conclusion of the protest period, this docket should be closed upon the issuance of a consummating order.