

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION
COMMISSION

In the Matter of the Review of) DOCKET NO. UT-023003
Unbundled Loop and Switching Rates; the)
Deaveraged Zone Rate Structure; and)
Unbundled Network Elements, Transport,)
and Termination)
)

**REPLY TESTIMONY OF
ANTHONY J. FLESCH
ON BEHALF OF VERIZON NORTHWEST INC.**

DEPRECIATION

APRIL 20, 2004

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1 **I. INTRODUCTION**

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

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

7 **Q. WHAT IS THE PURPOSE OF YOUR REPLY TESTIMONY?**

8 A. My reply testimony has two purposes. First, I adopt the direct testimony
9 of Verizon Northwest Inc. ("Verizon NW") witness Allen Sovereign filed
10 in this docket on June 26, 2003. Second, I respond to the
11 recommendations in the direct testimony and supplemental direct
12 testimony of Thomas L. Spinks on behalf of the Staff of the Washington
13 Utilities and Transportation Commission ("WUTC"), and the direct
14 testimony and supplemental direct testimony of Dr. Robert A. Mercer on
15 behalf of AT&T Communications of the Pacific Northwest, Inc. ("AT&T"),
16 regarding the depreciation inputs to be used in TELRIC cost studies in
17 Washington.

18 **II. ADOPTION OF SOVEREIGN DIRECT TESTIMONY**

19 **Q. PLEASE BRIEFLY DESCRIBE YOUR EDUCATIONAL AND**
20 **PROFESSIONAL BACKGROUND.**

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

1 forecasting. I have also developed and taught courses on depreciation
2 life analysis and technology forecasting provided by the Society of
3 Depreciation Professionals (“SDP”).

4 I am a Senior Member of the SDP and have served on the SDP
5 Executive Board of Directors in several capacities, including President,
6 Vice-President, Director, and Chair of the SDP Ethics and Standards
7 Committee. I am currently serving as Chair of the SDP Training
8 Administration Subcommittee, SDP Journal Editor, and Chair of the
9 Journal Review Committee, and have been a member of the SDP
10 Current Issues Committee since its inception in 2001. I have also
11 developed and instructed SDP training courses in Depreciation Life
12 Cycle Analysis and Technology Forecasting. The goal of SDP is to
13 recognize and promote professional development and ethics within the
14 field of depreciation and provide information of interest to depreciation
15 professionals.

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

1 **Q. PLEASE BRIEFLY DESCRIBE YOUR WORK EXPERIENCE WITH**
2 **VERIZON AND YOUR RESPONSIBILITIES IN YOUR CURRENT**
3 **POSITION.**

4 A. I have worked for Verizon for over twenty-seven years, with sixteen of
5 those years in the Depreciation study area. I have held various
6 positions of increasing responsibility in Engineering and Construction,
7 Network Operations, and Finance. I was named to my current position
8 in June of 2000 upon the merger of GTE and Bell Atlantic, which formed
9 Verizon Communications.

10 **Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE ANY OTHER**
11 **REGULATORY BODIES?**

12 A. Yes, I have presented written or oral testimony before the Alabama
13 Public Service Commission, Arkansas Public Service Commission,
14 Florida Public Service Commission, Illinois Commerce Commission,
15 Minnesota Public Utilities Commission, Missouri Public Service
16 Commission, Nebraska Public Service Commission, Nevada Public
17 Service Commission, and the North Carolina Utilities Commission. I
18 have also testified before the Circuit Court of Florida on depreciation
19 issues related to property tax.

20 **Q. HAVE YOU REVIEWED THE DIRECT TESTIMONY OF VERIZON NW**
21 **WITNESS ALLEN SOVEREIGN, FILED IN THIS DOCKET ON JUNE**
22 **26, 2003?**

23 A. Yes, and I adopt that testimony.

1 **III. THE DEPRECIATION INPUTS RECOMMENDED BY STAFF AND**
2 **AT&T DO NOT COMPLY WITH TELRIC AND ARE OUTDATED.**

3 **Q. WHAT DEPRECIATION INPUTS DO STAFF AND AT&T PROPOSE**
4 **SHOULD BE USED IN UNE COST STUDIES IN WASHINGTON?**

5 A. Staff and AT&T propose that rates for UNEs in Washington be
6 calculated using the depreciation inputs prescribed by the WUTC for
7 Verizon NW for regulatory accounting purposes in Docket No. UT-
8 992009 in the year 2000.¹

9 **Q. IS IT APPROPRIATE TO USE IN THIS PROCEEDING THE**
10 **DEPRECIATION INPUTS PRESCRIBED IN DOCKET NO. UT-992009?**

11 A. No. The depreciation inputs developed by the WUTC in Docket No. UT-
12 992009 are inappropriate for use in this proceeding, for two primary
13 reasons. First, the purpose of the prior proceeding was to calculate
14 retail rates for Verizon NW's customers under a rate-of-return regulatory
15 regime whose requirements and underlying assumptions are far
16 different than those under TELRIC. Second, the depreciation inputs
17 adopted in the prior proceeding are now nearly four years old and do not
18 account for the competitive and technological developments that have
19 occurred since 2000, all of which have substantially shortened the useful
20 lives of Verizon NW's assets.

¹ See Before the Washington Utilities and Transportation Commission, Docket No. UT-023003, *Supplemental Direct Testimony of Thomas L. Spinks* (Jan. 26, 2004) at p. 9 ("Spinks Supplemental Direct Testimony"); Before the Washington Utilities and Transportation Commission, Docket No. UT-023003, *Supplemental Direct Testimony of Dr. Robert A. Mercer* (rev. Apr. 9, 2004) at pp. 35-36.

1 **Q. WHY ARE DEPRECIATION INPUTS ADOPTED IN THE CONTEXT OF**
2 **REGULATORY RATEMAKING INAPPROPRIATE FOR USE IN A UNE**
3 **COST STUDY?**

4 A. A regulatory ratemaking proceeding is governed by fundamentally
5 different principles than those governing a UNE cost case. The purpose
6 of a regulatory ratemaking proceeding is to allow an incumbent to
7 recover its historical costs -- that is, the costs of its embedded assets.
8 Thus, rates developed in such a proceeding are determined based on
9 the level of competition, and the specific assets that exist, *at the time of*
10 *the proceeding*. As a result, the depreciation inputs prescribed by the
11 WUTC In Docket No. UT-992009 are inherently backward-looking, as
12 they are based on the level of competition and the network that existed
13 in 2000.

14 By contrast, a UNE cost study conducted pursuant to TELRIC
15 requires fundamentally different assumptions. As the FCC recently
16 confirmed, TELRIC assumes the existence of full competition and the
17 deployment of the least-expensive, most-efficient technology that is
18 currently available.² Thus, in marked contrast to rate-of-return
19 regulation, TELRIC is forward-looking. In fact, the Telecommunications
20 Act of 1996 expressly prohibits the use of rate-of-return regulation,

² See Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, 18 FCC Rcd 16978 ¶¶ 670, 681 & n.2048 (2003) (“*Triennial Review Order*”).

1 which bases rates on historical costs, to set wholesale UNE rates.³
2 Accordingly, even if the depreciation inputs prescribed by the WUTC in
3 Docket No. UT-990029 were appropriate for regulatory ratemaking
4 purposes (and Verizon NW maintains that those particular inputs are not
5 appropriate for that purpose), they are not at all appropriate for purposes
6 of calculating UNE rates.

7 **Q. WHY ARE DEPRECIATION INPUTS ADOPTED IN 2000 NOT**
8 **APPROPRIATE FOR USE IN A UNE COST STUDY?**

9 A. Depreciation inputs adopted in 2000 could not possibly account for the
10 many competitive and technological changes that have occurred since
11 that time, all of which have significantly shortened the lives of Verizon
12 NW's assets.

13 **Q. HAS VERIZON NW PRESENTED ADDITIONAL EVIDENCE OF**
14 **COMPETITIVE AND TECHNOLOGICAL CHANGE?**

15 A. Yes. The direct testimony of Verizon NW witness Harold E. West III,
16 filed on June 26, 2003, describes the many significant developments
17 that have occurred in recent years, which have caused Verizon NW's
18 customers to switch to intermodal and other facilities-based providers
19 and thus have limited the useful lives of Verizon NW's assets. The

³ See 47 U.S.C. § 252(d)(1)(A)(i) (providing that wholesale UNE rates must be based on the "cost . . . determined without reference to a rate-of-return or other rate-based proceeding . . . of providing the . . . network element") (emphasis added).

1 speed with which these developments have occurred has increased
2 substantially since the time of the WUTC's decision in 2000.

3 **Q. DOES STAFF WITNESS SPINKS SUGGEST THAT THE**
4 **DEPRECIATION INPUTS PRESCRIBED BY THE WUTC IN 2000**
5 **SHOULD BE UPDATED?**

6 A. Yes. Staff witness Spinks states that "Staff has a number of questions
7 about whether Verizon's asset lives and depreciation rates should first
8 be updated" ⁴ But whether or not the depreciation lives are updated
9 for regulatory accounting purposes, they still must be adjusted (if they
10 are used at all) to reflect the forward-looking TELRIC assumptions of a
11 fully competitive market and the adoption of new technology.

12 **IV. THE WUTC SHOULD USE GAAP LIVES IN UNE COST STUDIES.**

13 **Q. WHAT DEPRECIATION LIVES ARE APPROPRIATE FOR USE IN**
14 **THE COST MODELS, AND WHY?**

15 A. The depreciation lives recommended in my adopted direct testimony are
16 the appropriate inputs for use in the cost models. These are the same
17 depreciation lives that Verizon NW uses for financial reporting purposes.
18 These lives, which are based on Generally Accepted Accounting
19 Principles ("GAAP"), are updated annually and reflect the most current
20 view of the assets' useful life. The financial reports are also reviewed
21 and approved by Verizon's independent auditors. Even though these

⁴ Spinks Supplemental Direct Testimony at 13.

1 lives are more up-to-date and forward-looking than the regulatory lives
2 adopted by the WUTC four years ago, they still do not fully account for
3 all of the risks inherent in a view of TELRIC that assumes full
4 competition and the construction of a brand new network every three to
5 five years. Rather, GAAP lives take into account current and expected
6 near-term competition. These lives thus reflect a more conservative
7 estimate of the useful lives of Verizon NW's assets than is required
8 under TELRIC.

9 **Q. HAVE ANY OTHER STATES ADOPTED GAAP LIVES FOR UNE**
10 **COST STUDIES SINCE VERIZON NW FILED ITS DIRECT**
11 **TESTIMONY?**

12 A. Yes. In January 2004, the Indiana Utility Regulatory Commission
13 approved the use of GAAP lives in UNE cost studies, stating that this
14 approach "is more appropriate . . . in light of TELRIC and the overall
15 goals of the 1996 Act."⁵ As the Indiana Commission explained,
16 "Technological advancement continues at a rapid pace, leading to faster
17 obsolescence of all types of telecommunications equipment. If anything,
18 the pace of technological advancements should only increase as
19 unbundling and pricing determinations are brought more in line with the
20 goals of the 1996 Act in the wake of the 1999 Biennial Order, the

⁵ 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 67 (Ind. Util. Reg. Comm'n Jan. 5, 2004).

1 Triennial Review Order, and the TELRIC NPRM, and as the incentive for
2 facilities-based investment and innovation increases.”⁶ The Indiana
3 Commission found that using GAAP lives would provide an incentive to
4 use these rapidly developing new technologies, stating, “We want to
5 encourage SBC Indiana to take advantage of and deploy technological
6 advancements, and one way to do that is to allow it to use reasonable
7 depreciation lives based on criteria [employed] for financial reporting
8 purposes.”⁷ In addition, the Indiana Commission concluded that
9 competition warranted the use of GAAP lives. Citing the FCC’s *Triennial*
10 *Review Order*, the Indiana Commission stated that “the increase in
11 competition faced by [ILECs], both intermodal and intramodal, compels
12 use of shorter depreciation lives.”⁸

13 **Q. IS STAFF CORRECT THAT THE FCC REJECTED THE USE OF**
14 **FINANCIAL REPORTING LIVES IN TELRIC STUDIES?**⁹

15 A. No. In its *Triennial Review Order*, the FCC declined to adopt either
16 financial reporting lives or regulatory lives for use in calculating
17 depreciation in UNE cost studies. Instead, the FCC made clear that
18 state commissions retain discretion to select the depreciation

⁶ *Id.*

⁷ *Id.* at 68.

⁸ *Id.* (citing *Triennial Review Order* ¶ 685).

⁹ Spinks Supplemental Direct Testimony at 12.

1 methodology and inputs that most closely comply with TELRIC's
2 requirements.

3 **V. CONCLUSION**

4 **Q. DOES THIS CONCLUDE YOUR REPLY TESTIMONY?**

5 **A. Yes.**