

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)
)

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

DEPRECIATION

MAY 12, 2004

TABLE OF CONTENTS

- I. INTRODUCTION 1
- II. THE OBJECTIONS RAISED BY MR. SPINKS AND MR. LUNDQUIST TO VERIZON NW'S PROPOSED GAAP LIVES ARE BASED ON INCORRECT ASSUMPTIONS CONCERNING GAAP, TELRIC, AND VERIZON NW'S METHODOLOGY..... 3
 - A. GAAP DOES NOT REQUIRE, AND IN FACT EXPRESSLY PROHIBITS, THE UNDERSTATEMENT OF DEPRECIATION LIVES..... 3
 - B. UNDER TELRIC, ASSET LIVES MUST TAKE INTO ACCOUNT *FUTURE* COMPETITION..... 6
 - C. VERIZON NW USES APPROPRIATE BENCHMARKS TO CONFIRM THE REASONABLENESS OF ITS GAAP LIVES. 8
 - D. THE OTHER POINTS RAISED BY MR. SPINKS AND MR. LUNDQUIST ARE LIKEWISE INVALID..... 11
- III. CONCLUSION 13

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. HAVE YOU PREVIOUSLY FILED TESTIMONY IN THIS**
8 **PROCEEDING?**

9 A. Yes. I filed reply testimony on behalf of Verizon Northwest Inc.
10 (“Verizon NW”) on April 20, 2004. In that reply testimony, I adopted the
11 direct testimony of Allen Sovereign filed on behalf of Verizon NW on
12 June 26, 2003

13 **Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?**

14 A. The purpose of my rebuttal testimony is to respond to the arguments in
15 the Response Testimony filed by Thomas L. Spinks on behalf of the
16 Washington Utilities and Transportation Commission (“WUTC”) Staff
17 and the Responsive Testimony filed by Scott C. Lundquist on behalf of
18 AT&T Communications of the Pacific Northwest, Inc., (“AT&T”),
19 regarding the depreciation inputs to be used for calculating rates for
20 unbundled network elements (“UNEs”) in Washington.

21 **Q. PLEASE SUMMARIZE YOUR REBUTTAL TESTIMONY.**

22 A. The objections raised by Mr. Spinks and Mr. Lundquist to the use of
23 Verizon NW’s proposed depreciation lives are based on an incorrect

1 understanding of the principles underlying those lives and of the
2 principles underlying TELRIC generally. Verizon NW's proposed
3 depreciation lives, which comply with Generally Accepted Accounting
4 Principles ("GAAP"), represent the best estimate of Verizon NW's asset
5 lives. Contrary to Mr. Lundquist's claim, GAAP lives are not biased by
6 conservatism; that principle was long ago rescinded as part of GAAP,
7 and GAAP now prohibits such bias and requires accuracy. In addition,
8 Mr. Spinks's observation concerning current competition is not relevant
9 to determining TELRIC-compliant depreciation lives. The Federal
10 Communications Commission ("FCC") has stated that UNE rates must
11 reflect *future* competitive conditions, as Verizon NW's GAAP lives do.
12 Furthermore, Mr. Lundquist mischaracterizes Verizon NW's use of
13 benchmarks to assess the reasonableness of its proposed lives. The
14 benchmarks relied on by Verizon NW reflect the same forward-looking
15 principles as Verizon NW's lives.

16 The WUTC should therefore use Verizon NW's proposed
17 depreciation lives to set UNE rates, rather than the depreciation inputs it
18 prescribed for Verizon NW for regulatory accounting purposes in Docket
19 No. UT-992009 in the year 2000. As I explained in my reply testimony,
20 those previously prescribed inputs are outdated and reflect a rate-of-
21 return regulatory regime that is inherently backward-looking, and thus

1 conflict with the forward-looking approach that defines TELRIC.¹
2 Indeed, Congress explicitly prohibited state commissions from relying on
3 a rate-of-return methodology when setting UNE rates pursuant to
4 TELRIC.²

5 **II. THE OBJECTIONS RAISED BY MR. SPINKS AND MR. LUNDQUIST**
6 **TO VERIZON NW’S PROPOSED GAAP LIVES ARE BASED ON**
7 **INCORRECT ASSUMPTIONS CONCERNING GAAP, TELRIC, AND**
8 **VERIZON NW’S METHODOLOGY.**

9 **A. GAAP DOES NOT REQUIRE, AND IN FACT EXPRESSLY**
10 **PROHIBITS, THE UNDERSTATEMENT OF DEPRECIATION**
11 **LIVES.**

12 **Q. IS MR. LUNDQUIST CORRECT THAT GAAP REQUIRES**
13 **DEPRECIATION LIVES TO BE CONSERVATIVE?**

14 A. No. Mr. Lundquist claims that GAAP is governed by the principle of
15 “conservatism,” which requires a company’s financial reporting to be
16 conservative in order to protect the interests of investors.³ The result of
17 such an approach, he claims, would be shorter depreciation lives
18 intended to avoid understating expense and overstating net income.⁴
19 However, the Financial Accounting Standards Board (“FASB”), which
20 authors GAAP, has taken a series of actions to ensure that such

¹ See Before the Washington Utilities and Transportation Commission, Docket No. UT-023003, *Reply Testimony of Anthony J. Flesch* (April 20, 2004) at pp. 4-6 (“Flesch Reply Testimony”).

² 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).

³ See Before the Washington Utilities and Transportation Commission, Docket No. UT-023003, *Responsive Testimony of Scott C. Lundquist* (April 20, 2004) at pp. 43-44 (“Lundquist Responsive Testimony”).

1 conservatism is *excluded* from GAAP. Over two decades ago, the
2 FASB excluded the concept of conservatism from the hierarchy of
3 GAAP principles,⁵ redefined it to mean “prudence,”⁶ and relegated it to a
4 minor role.⁷ The FASB reinforced the inapplicability of the conservatism
5 principle over a decade ago, by officially and expressly rescinding its
6 previous definition of the concept as a part of GAAP.⁸ Therefore,
7 conservatism as described by Mr. Lundquist played no role in the
8 development of Verizon NW’s depreciation lives.

9 **Q. DOES GAAP PROHIBIT A COMPANY FROM UNDERSTATING ITS**
10 **DEPRECIATION EXPENSES?**

11 A. Yes. Although Mr. Lundquist claims that companies use GAAP to
12 overstate their depreciation expenses, GAAP expressly prohibits this
13 biased, results-oriented approach. In fact, GAAP specifically requires
14 that the data used in financial reporting contain no “bias intended to
15 attain a predetermined result or to induce a particular mode of

4 *See id.* at 43.

5 FASB Statement of Financial Accounting Concepts No. 2, “Qualitative Characteristics of Accounting Information,” Figure 1 at 20, Glossary (May 1980) (“FASB Concept Statement 2”).

6 *Id.*, Glossary at 10 (defining “conservatism” as a “prudent reaction to uncertainty to try to ensure that uncertainty and risks inherent in business situations are adequately considered”).

7 *Id.* ¶ 93 (“Conservatism in financial reporting should no longer connote deliberate, consistent understatement of net assets and profits.”).

8 Statement of Position 93-3, “Rescission of Accounting Principles Board Statements,” ¶ 7 (Mar. 1993).

1 behavior.”⁹ GAAP instead requires that representations made in a
2 company’s financial statements, including statements reflecting
3 depreciation expense, be reliable and neutral.¹⁰

4 **Q. ARE THESE REQUIREMENTS OF GAAP ENFORCED?**

5 A. Yes. Many safeguards exist to ensure that companies accurately and
6 reliably describe their depreciation lives and other financial information
7 as GAAP requires. For example, as described in my adopted direct
8 testimony, Verizon NW’s external auditors review its depreciation lives
9 to ensure their compliance with GAAP.¹¹ In addition, all companies
10 have numerous incentives to accurately state their depreciation lives.

11 **Q. PLEASE DESCRIBE THE INCENTIVES THAT COMPANIES HAVE TO**
12 **AVOID UNDERSTATING THE DEPRECIATION LIVES USED IN**
13 **THEIR FINANCIAL REPORTS.**

14 A. There are many reasons why a company would not want to understate
15 its depreciation lives in the manner suggested by Mr. Lundquist. First,
16 doing so may actually harm investors. Shorter lives produce higher
17 expenses, lower net income, and lower asset values. All of this may
18 *lower* stock prices, which is clearly not in the interest of investors.
19 Second, these same financial effects may cause concern for creditors,

⁹ FASB Concept Statement 2, Figure 1 at 20.

¹⁰ *Id.*; FASB, *Statement of Financial Accounting Concepts No. 1*, “Objectives of Financial Reporting by Business Enterprises,” at 16 ¶ 33 (1978).

¹¹ See Before the Washington Utilities and Transportation Commission, Docket No. UT-023003, *Direct Testimony of Allen E. Sovereign* (June 26, 2003) at p. 5 (“Sovereign Direct Testimony”).

1 prompting them to raise their interest rates and thus make it more
2 expensive for a company to borrow. Finally, any inaccuracies in a
3 company's financial statements may subject the company's officers to
4 various civil and criminal penalties.¹²

5 **Q. HAS GAAP BEEN ENDORSED BY ANY INDEPENDENT**
6 **ORGANIZATIONS?**

7 A. Yes. The American Institute of Certified Public Accountants has
8 officially recognized GAAP as authoritative.¹³

9 **Q. HAVE ANY FEDERAL AGENCIES ENDORSED GAAP?**

10 A. Yes. The Securities and Exchange Commission requires that
11 companies use GAAP in their financial reporting.¹⁴ Similarly, the
12 Departments of Defense, Agriculture, and Energy, as well as the Small
13 Business Administration, have incorporated GAAP into their rules.¹⁵

14 **B. UNDER TELRIC, ASSET LIVES MUST TAKE INTO ACCOUNT**
15 **FUTURE COMPETITION.**

16 **Q. IS MR. SPINKS'S ASSERTION REGARDING CURRENT**
17 **COMPETITION IN WASHINGTON RELEVANT TO WHETHER**

¹² 17 C.F.R. § 229.601; 18 U.S.C. §§ 1350(c), 1341.

¹³ See FASB, *Statement of Financial Accounting Standards No. 101 -- Regulated Enterprises -- Accounting for the Discontinuation of Application of FASB Statement No. 71* (1988); American Institute of Certified Public Accountants, Code of Professional Conduct, Rule 203 (effective Nov. 30, 1993).

¹⁴ 15 U.S.C. § 78m(i); 17 C.F.R. § 210.4-01(a)(1).

¹⁵ 48 C.F.R. § 31.201-2(a)(3) (Department of Defense); 7 C.F.R. § 277.11(d)(2) (Department of Agriculture); 10 C.F.R. § 765.20(f) (Department of Energy); 13 C.F.R. § 124.602(d) (Small Business Administration).

1 **VERIZON NW’S PROPOSED DEPRECIATION LIVES ARE**
2 **APPROPRIATE?**

3 A. No. Mr. Spinks claims that Verizon NW “has no effective competition in
4 its service area,” suggesting that Verizon NW’s asset lives have not
5 been reduced or otherwise impacted by competitive forces.¹⁶ As an
6 initial matter, this is factually incorrect, for the reasons described in the
7 direct testimony filed on behalf of Verizon NW by Harold E. West III.¹⁷
8 But regardless of its accuracy, this observation is irrelevant to the
9 WUTC’s analysis of depreciation for purposes of setting UNE rates.
10 UNE rates must be based on TELRIC, which requires a forward-looking
11 approach to setting depreciation lives. The FCC has stated that this
12 requires consideration of *future* competitive risk.¹⁸ Therefore, even if
13 Verizon NW did not face substantial competition *today*, the relevant
14 question under TELRIC is the extent to which it will face competition in
15 the future.

16 **Q. WILL VERIZON NW’S ASSET LIVES BE REDUCED BY FUTURE**
17 **COMPETITION?**

¹⁶ See Before the Washington Utilities and Transportation Commission, Docket No. UT-023003, *Response Testimony of Thomas L. Spinks* (April 20, 2004) at p. 11 (“Spinks Response Testimony”).

¹⁷ See *generally* Before the Washington Utilities and Transportation Commission, Docket No. UT-023003, *Direct Testimony of Harold E. West III* (June 26, 2003) at pp. 2-12 (“West Direct Testimony”).

¹⁸ 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 ¶ 681 n.2048 (2003) (“*Triennial Review Order*”).

1 A. Yes. As explained in Mr. West's direct testimony, numerous providers --
2 including competitive local exchange carriers, wireless services,
3 Internet-based services, cable television company networks, and
4 government-owned networks -- are already serving an increasing
5 number of lines in Washington and making significant investment in
6 facilities that will continue to compete directly with Verizon NW.¹⁹ This
7 investment will produce increased competition going forward, placing
8 pressure on Verizon NW's service volumes and revenues, and
9 rendering its current assets obsolete more quickly.

10 **C. VERIZON NW USES APPROPRIATE BENCHMARKS TO**
11 **CONFIRM THE REASONABLENESS OF ITS GAAP LIVES.**

12 **Q. PLEASE EXPLAIN HOW VERIZON NW USES BENCHMARKING IN**
13 **DEVELOPING ITS PROPOSED DEPRECIATION LIVES.**

14 A. Verizon NW uses benchmarking to check the reasonableness of its
15 proposed depreciation lives. But as explained in my adopted direct
16 testimony, Verizon NW first considers a number of factors to develop
17 estimates of the lives of its assets.²⁰ These factors include current
18 network modernization strategies; the likely future impact of technology
19 and obsolescence; the competitive environment in the forward-looking
20 marketplace; regulatory commitments; state demographics; and
21 traditional wear and tear.²¹ After developing its own estimates of its

¹⁹ See generally West Direct Testimony at 2-12.

²⁰ Sovereign Direct Testimony at 7-8.

²¹ *Id.*

1 asset lives, Verizon NW compares those estimates to the depreciation
2 lives used by its competitors -- specifically, AT&T and MCI -- and those
3 developed in industry studies by Technology Futures Inc. ("TFI").

4 **Q. IS MR. LUNDQUIST CORRECT THAT THE BENCHMARKS USED BY**
5 **VERIZON NW TO ASSESS THE REASONABLENESS OF ITS**
6 **PROPOSED DEPRECIATION LIVES ARE INAPPROPRIATE FOR**
7 **TELRIC PURPOSES?**²²

8 A. No. Mr. Lundquist first claims that Verizon NW's use of benchmarking is
9 a "fruitless exercise" because these other lives, which are based on
10 GAAP, reflect the conservatism principle and are thus too low.²³ But as
11 I explained above, GAAP is *not* governed by the conservatism principle,
12 and in fact expressly prohibits the type of results-oriented analysis that
13 Mr. Lundquist describes. In fact, if AT&T's GAAP lives do reflect the
14 conservatism principle as Mr. Lundquist suggests, then AT&T's lives are
15 not GAAP-compliant.

16 **Q. HAS VERIZON NW SOUGHT DISCOVERY REGARDING AT&T'S**
17 **GAAP LIVES?**

18 A. Yes. Verizon NW recently served discovery requests on AT&T seeking
19 information concerning AT&T's depreciation lives. In its discovery
20 responses served on May 11, 2004, AT&T stated that it is attempting to
21 obtain this information. Verizon NW therefore reserves the right to

²² Lundquist Responsive Testimony at 44-45.

²³ *Id.* at 45.

1 supplement this rebuttal testimony as appropriate upon receiving that
2 discovery.

3 **Q. DOES VERIZON NW BASE ITS DEPRECIATION LIVES ON STUDIES**
4 **BY TFI?**

5 A. No. As I explained above, Verizon NW independently considers the
6 relevant factors and develops its own estimates of its asset lives. It then
7 compares those estimates to various benchmarks, including, but not
8 limited to, those developed by TFI. Verizon NW by no means “bases” its
9 asset lives on the studies prepared by TFI, as Mr. Lundquist suggests.²⁴

10 **Q. DOES MR. LUNDQUIST ACCURATELY CHARACTERIZE TFI’S**
11 **TRACK RECORD FOR ESTIMATING ASSET LIVES?**

12 A. No. Mr. Lundquist claims that TFI’s asset life forecasts are not a
13 meaningful comparison in light of TFI’s alleged “poor track record” in
14 forecasting the rate at which new technologies replace existing
15 technologies.²⁵ TFI’s actual track record, however, is far more
16 successful than Mr. Lundquist indicates. For example:

17 • In 1986, TFI projected that local switching would be all digital
18 by 1997-2000, while most of the industry thought most analog
19 electronic switches would survive the 1990s. Actually, digital
20 switching adoption reached 98% by 2000.²⁶

²⁴ *Id.* at 46.

²⁵ *Id.*

²⁶ <http://www.tfi.com/about/index.html#record> (last visited May 10, 2004).

- 1 • In 1987, TFI projected that wireless phones would compete
2 with wireline by the late 1990s, while most industry sources
3 projected that wireless would remain a niche market,
4 complementary to wireline. In fact, there were 100 million
5 U.S. wireless subscribers in 2000, many of whom used
6 wireless as a substitute for wireline service.²⁷
- 7 • In 1990, TFI projected that a mass market for digital
8 communications services would develop during the decade,
9 while most industry sources predicted that digital services
10 would remain a niche market. By 2001, there were almost 10
11 million broadband customers.²⁸

12 **D. THE OTHER POINTS RAISED BY MR. SPINKS AND MR.**
13 **LUNDQUIST ARE LIKEWISE INVALID.**

14 **Q. DOES THE FCC WIRELINE COMPETITION BUREAU'S DECISION IN**
15 **THE VIRGINIA ARBITRATION AFFECT WHICH SET OF**
16 **DEPRECIATION LIVES SHOULD BE ADOPTED IN THIS**
17 **PROCEEDING?**

- 18 A. No. The FCC Wireline Competition Bureau (*i.e.*, the FCC's staff)
19 recently declined to adopt Verizon VA's proposal to use GAAP lives.
20 However, that ruling was not based on any perceived deficiency in
21 GAAP lives. Rather, the Bureau decided not to use GAAP lives based
22 on its desire for more information about Verizon's use of that

²⁷ *Id.*

²⁸ *Id.*

1 methodology.²⁹ That staff-level, record-specific decision therefore is not
2 dispositive of whether the WUTC should use GAAP lives to set UNE
3 rates in Washington in this proceeding.

4 **Q. PLEASE RESPOND TO MR. SPINKS'S RECOMMENDATION THAT**
5 **THE WUTC DEFER CONSIDERATION OF DEPRECIATION RATES IN**
6 **THIS PROCEEDING UNTIL AFTER THE CONCLUSION OF ITS**
7 **REVIEW IN DOCKET NO. UT-040520.**³⁰

8 A. As Mr. Spinks notes, Verizon NW recently filed a depreciation study in
9 Docket No. UT-040520. That docket is designed to set retail rates, as
10 opposed to the wholesale UNE rates at issue in this proceeding. That
11 study reflects the same GAAP lives that Verizon NW has proposed in
12 this proceeding. The fact that the WUTC will consider those lives for a
13 different purpose in Docket No. UT-040520 should not affect the
14 WUTC's deliberations in this proceeding. However, if the WUTC in
15 Docket No. UT-040520 adopts depreciation lives other than those
16 proposed there by Verizon NW, then those lives should not be used in
17 this proceeding, because they would not reflect the level of competition
18 and technology assumed under TELRIC.

²⁹ See Memorandum Opinion and Order, *Petition of WorldCom, Inc. Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc., and for Expedited Arbitration*, 17 FCC Rcd 27039 ¶ 116 (2002) (“*Virginia Arbitration Order*”).

³⁰ Spinks Response Testimony at 10.

1 **III. CONCLUSION**

2 **Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

3 **A. Yes.**