Exhibit No. ___ (AES-1T)
Docket No. UT-023003

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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

DIRECT TESTIMONY OF ALLEN E. SOVEREIGN ON BEHALF OF VERIZON NORTHWEST INC.

DEPRECIATION

June 26, 2003

TABLE OF CONTENTS

I. INTRODUCTION 1

II. ECONOMIC LIVES MUST BE USED IN FORWARD-LOOKING COST STUDIES. 3

III. VERIZON PROPERLY WEIGHED ALL RELEVANT FACTORS IN DETERMINING ITS ECONOMIC LIVES. 6

IV. VERIZON USED BENCHMARKING TO VALIDATE ITS ECONOMIC LIVES 10

V. VERIZON'S ECONOMIC LIVES HAVE BEEN ENDORSED BY OTHER STATE REGULATORY COMMISSIONS AND THE FCC 14

VI. CONCLUSION. 16

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME, ADDRESS AND CURRENT POSITION.

A. My name is Allen E. Sovereign. My business address is 600 Hidden Ridge, Irving, Texas 75038. I am Group Manager-Capital Recovery for Verizon Services Organization, Inc.

Q. PLEASE BRIEFLY DESCRIBE YOUR EDUCATIONAL BACKGROUND.

A. I received a Bachelor of Science Degree in Electrical Engineering from Michigan Technological University, Houghton, Michigan, in 1971. I received a Master of Science Degree in Business Administration from Indiana University, Bloomington, Indiana, in 1980. I have attended courses in depreciation and life analysis conducted by Depreciation Programs, Inc., of Kalamazoo, Michigan. I have also attended and instructed basic and advanced GTE courses in depreciation life analysis. I am a Senior Member of the Society of Depreciation Professionals.

Q. PLEASE BRIEFLY DESCRIBE YOUR WORK EXPERIENCE WITH VERIZON AND YOUR RESPONSIBILITIES IN YOUR CURRENT POSITION.

A. I have worked for Verizon and its predecessor companies for over 29 years, with 22 of those years in the depreciation study area. I have held various positions in Engineering and Construction, Capital Budgeting, Marketing, and Product Development. I was named to my current position in June of 2000 upon the merger of GTE and Bell Atlantic, which formed Verizon Communications.

Q. HAVE YOU PREVIOUSLY TESTIFIED IN WASHINGTON?

A. Yes. I previously provided testimony in the GTE depreciation docket (UT-961632) and the GTE UNE docket (UT-960369, UT-960370, and UT-960371).

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

A. Yes, I have testified before the FCC, as well as state utility commissions in Arkansas, California, Hawaii, Florida, Idaho, Illinois, Indiana, Iowa, Kentucky, Maryland, Massachusetts, Michigan, Nebraska, Nevada, New Mexico, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas, Virginia, and Washington, D.C.

Q. WHAT IS THE PURPOSE OF YOUR DIRECT TESTIMONY?

A. The purpose of this testimony is to recommend depreciation lives and future net salvages to be used in the cost studies to calculate unbundled network element ("UNE") rates for Verizon Northwest Inc. ("Verizon NW") in this proceeding. I will also explain why the depreciation lives contained in Verizon NW's studies are the appropriate inputs for determining Verizon NW's forward-looking UNE rates.

Q. PLEASE SUMMARIZE YOUR DIRECT TESTIMONY.

A. This Commission should adopt the economic depreciation inputs Verizon NW used in its cost studies, which are the same depreciation lives that Verizon NW uses for financial reporting purposes. These lives represent a conservative, forward-looking approach that takes into account the anticipated decline in an asset's value from various causes, including competition and technological change. This forward-looking approach produces a more accurate estimate of assets' economic lives than an outdated, historical approach, although it does not

fully account for the risks inherent in a view of TELRIC that assumes the construction of a brand new network every three to five years.

Q. HOW IS YOUR TESTIMONY ORGANIZED?

A. In Section II, I discuss why the economic lives recommended by Verizon NW are the correct depreciation lives to use in its cost studies. In Section III, I discuss the relevant factors in determining depreciation lives, including the impact of competition and technology on depreciation lives. In Section IV, I provide benchmark comparisons showing the reasonableness of Verizon NW's recommended lives as compared to those used by Verizon's competitors. Finally, in Section V, I reference decisions in other states and by the FCC that further support Verizon NW's proposed depreciation lives.

II. ECONOMIC LIVES MUST BE USED IN FORWARD-LOOKING COST STUDIES.

Q. PLEASE DEFINE THE TERM "ECONOMIC LIFE" AND HOW IT RELATES TO COST STUDIES.

A. The economic life of an asset is the period of time over which an asset is used to provide economic value (*i.e.*, by producing sufficient revenue to cover its costs). Economic depreciation, in turn, is the change in value of a depreciable asset during this period. Verizon NW's proposed depreciation inputs consider the decline in an asset's value from competition, technological change, ordinary wear and tear, and regulatory developments. These inputs reflect the principle that depreciation should be consistent with forward-looking economic assumptions and based on competitive market asset lives.

Q. IS AN ASSET'S ECONOMIC LIFE EQUAL TO THE DEPRECIATION LIFE OF THAT ASSET AS PRESCRIBED BY A REGULATORY COMMISSION FOR ACCOUNTING PURPOSES?

A. No. Economic lives are generally shorter than such prescribed asset lives. This is because the lives prescribed by regulatory commissions — such as those previously prescribed by the FCC — were used only for regulatory accounting purposes and bore little relationship to the real economic life of the asset. When incumbent local exchange carriers ("ILECs") were the sole providers of local exchange service, regulators set depreciation rates based on long asset lives more reflective of asset mortality than true economic life. By basing depreciation rates on long asset lives, the depreciation rates were lower, and the period of time over which the asset depreciated was deemed longer. These longer depreciation lives helped state commissions keep consumer prices artificially low while arguably still permitting an ILEC to recover its investment over some extended period of time.

With the 1996 Act, however, Congress intended to spur a new competitive environment that invalidated the basic assumptions under which the FCC's prescribed asset lives were adopted. Increased competition and technological change — which are foremost among the intended results of the 1996 Act — shorten the period over which an asset will provide economic value. Competitive forward-looking market environments thus reduce the length of time over which Verizon can recover its investment in an asset and render unsustainable the use of artificially long asset lives in calculating depreciation rates. Because

competition and technology in the telecommunications industry continue to develop, it is important that the economic lives used to calculate TELRIC rates take these factors into account.

Q. WHAT DEPRECIATION INPUTS DID VERIZON NW USE IN THE COST STUDIES IT SUBMITTED IN THIS PROCEEDING?

A. Verizon NW used the same forward-looking economic lives and future net salvage values that it uses in its external financial reports filed with the Securities and Exchange Commission and that it provides to its shareholders. These up-to-date economic lives, which have been scrutinized by Verizon's external auditors and the financial community, are consistent with generally accepted accounting principles ("GAAP"). As explained further below, these lives take into account the current and expected state of competition and technological innovation, among other relevant factors. Appended to my testimony as Exhibit AES-2 is a complete list of the proposed depreciation lives and future net salvage percentages used in Verizon NW's cost studies.

Q. DO VERIZON NW'S DEPRECIATION LIVES TAKE INTO ACCOUNT ALL OF THE RISKS THAT MUST BE ASSUMED PURSUANT TO TELRIC?

A. An approach based on GAAP cannot account for the assumption of perfect competition which the CLECs typically advocate in their cost proposals. Verizon NW's financial reporting lives are based on current and foreseeable market conditions. Verizon NW's proposed depreciation lives thus present a conservative approach to estimating TELRIC depreciation.

Q. HAS THE WASHINGTON COMMISSION PREVIOUSLY ADOPTED DEPRECIATION LIVES FOR VERIZON NW?

A. Yes. This Commission previously adopted longer depreciation lives than what Verizon NW now proposes. However, the considerations and circumstances that led the Commission to adopt those lives no longer apply, and the Commission should now adopt the updated, forward-looking GAAP lives that Verizon NW proposes in this proceeding.

Q. HOW DO THE DEPRECIATION LIVES USED IN VERIZON NW'S COST STUDY COMPARE TO THE LIVES VERIZON NW USES FOR FINANCIAL REPORTING PURPOSES?

A. The depreciation lives Verizon NW used in its cost study are the same as the lives Verizon NW used for financial reporting purposes in its 2002 annual report and SEC filings.

III. VERIZON PROPERLY WEIGHED ALL RELEVANT FACTORS IN DETERMINING ITS ECONOMIC LIVES.

Q. PLEASE EXPLAIN GENERALLY HOW VERIZON NW DEVELOPED ITS PROPOSED ECONOMIC LIVES.

A. To determine its proposed economic lives, Verizon NW considered current network modernization strategies; the likely future impact of technology and obsolescence; the competitive environment in the forward-looking marketplace; regulatory commitments; state demographics; and traditional wear and tear. Verizon NW also "benchmarked" lives currently used by other companies and reviewed independent industry studies of technology obsolescence.

While all of the above factors interrelate in determining the proper forward-looking economic lives used in Verizon NW's cost studies, the most important are the functional factors — in particular, competition and technological innovation — that reduce the depreciable value of an asset even though the asset remains "physically" intact. Technological and competitive changes are particularly important in setting economic lives for use in TELRIC studies, because TELRIC assumes a fully competitive market.

Q. PLEASE EXPLAIN IN MORE DETAIL HOW VERIZON NW APPLIED THE VARIOUS FACTORS THAT DETERMINE ECONOMIC LIVES.

A. Verizon NW first considered the National Association of Regulatory Utility Commissioners' ("NARUC") factors relating to the retirement of assets. These include:

1. Physical Factors
   a. Wear and tear
   b. Decay or deterioration
   c. Action of the elements and accidents

2. Functional Factors
   a. Inadequacy
   b. Obsolescence
   c. Changes in Art and Technology
   d. Changes in Demand
   e. Requirements of Public Authority
   f. Management Discretion

3. Contingent Factors
   a. Casualties or Disasters
   b. Extraordinary Obsolescence[1/]

1/ *Public Utility Depreciation Practices*, National Association of Regulatory Utility Commissioners ("NARUC") at 14-15 (1996).

Verizon NW used these same factors to help estimate an asset's economic life expectancy by allocating the appropriate weighting to each factor to reflect the significant roles competition and technological change play in determining an asset's economic life. For example, the "Functional Factors" (Part 2 of the NARUC factors noted above) are sensitive to competition and technological change, and therefore, were given substantially greater weight than other factors in establishing the economic lives of Verizon NW's assets. For the technology-driven accounts — digital switching account, circuit equipment account, and cable — the functional factors were given virtually exclusive weight relative to the other factors listed above. Verizon NW took a more traditional approach for the determination of economic lives for the remaining accounts, which are less dependent on technological change. For example, in accounts such as motor vehicles or furniture, past patterns of retirement may be more useful in predicting future economic lives.

Q. WHAT KINDS OF COMPETITIVE DEVELOPMENTS WERE CONSIDERED IN ESTABLISHING VERIZON'S ECONOMIC LIVES?

A. The study took into account the types of competitive developments described in Mr. West's testimony, which shows that wireless providers and facilities-based CLECs are serving Verizon NW's region and have been capturing Verizon NW customers.[2/]

[2/] *See* West Direct Testimony.

Q. HOW DOES COMPETITION DECREASE THE "ECONOMIC LIFE" OF AN ASSET?

A. As noted above, the economic life of an asset is the period of time over which an asset is used to provide economic value. Competition necessarily spurs technological development, which shortens the economic life of existing assets. Indeed, advances in technology can make assets obsolete even though the "physical asset" itself continues to function. This phenomenon is well-known to anyone who has bought a computer (or other state-of-the-art equipment) within the past several years. In a competitive world, a company that does not rationally deploy new technology will fail as customers look to competitors to provide the services they desire. Technological advances therefore decrease the "economic lives" of certain assets on a forward-looking basis, particularly when using TELRIC assumptions of the most efficient forward-looking network.

Q. WHAT TECHNOLOGICAL INNOVATIONS WERE CONSIDERED IN ESTABLISHING VERIZON NW'S ECONOMIC LIVES?

A. Competitive carriers are utilizing a number of alternative technologies to provide telecommunications services that completely bypass the existing wireline network of the ILEC. These technologies include wireless (cellular technology and wireless local loops), cable television lines, and electric lines. Prior to the passage of the 1996 Act, depreciation analysis consisted primarily of mortality analysis with only slight adjustments for technological change. Now, the rapid pace of advancement in technological innovations must be recognized in establishing the economic value of Verizon's assets.

IV. VERIZON USED BENCHMARKING TO VALIDATE ITS ECONOMIC LIVES.

Q. WHAT OTHER GUIDES DOES VERIZON NW USE IN ESTABLISHING ASSET LIVES?

A. To help quantify its professional judgment as to the appropriate lives for telephone plant, Verizon "benchmarks" (*i.e.*, compares) its lives against those of its competitors, such as WorldCom, AT&T, and cable television providers, and considers industry studies performed by Technology Futures, Inc. ("TFI").

Q. PLEASE EXPLAIN WHY BENCHMARKING IS USEFUL AND APPROPRIATE.

A. Benchmarking against competitors affords Verizon NW another vehicle to assess the reasonableness of its recommended depreciation lives. As Verizon NW transitions to a competitive environment, it should be treated the same as its competitors with respect to setting depreciation rates. Competitors' depreciation rates are not reviewed or approved by regulatory bodies in the same manner as Verizon's, and are a good guide to reasonable practices in a competitive market. A table illustrating the results of Verizon's Benchmarking Study is appended to this testimony as Exhibit AES-3.

Q. HAVE OTHER STATE COMMISSIONS USED SUCH BENCHMARKING TO ESTABLISH TELRIC RATES?

A. Yes. For example, the Missouri Public Service Commission compared Verizon's lives to the lives of the largest interexchange carriers ("IXC"), cable television ("CATV") operators, cellular providers, competitive access providers ("CAPs"), and personal communications services ("PCS") providers, and found that the depreciation for these companies were, in general, significantly shorter than

Verizon NW's lives. The Missouri Commission concluded that "benchmarking GTE TELRIC rates against those booked for financial purposes of likely competitors and other companies using similar technologies is appropriate and is the best method to determine if GTE's TELRIC rates pass the muster of reasonableness."[3/]

Q. HOW DO VERIZON NW'S ECONOMIC DEPRECIATION LIVES COMPARE WITH THOSE OF WORLDCOM AND AT&T?

A. As is demonstrated in Exhibit AES-3 to this testimony, Verizon NW's lives are actually longer than those used by AT&T, and are very comparable to those used by WorldCom. Specifically, Verizon NW used economic depreciation lives of 8 to 20 years (8 to 50 including Poles and Conduit) for communications and network equipment; 5 to 15 years for Other Equipment; and 25 years for buildings. In comparison, AT&T stated in its 2001 annual report that depreciation is based on the asset's useful life, which ranges from 3 to 15 years for communications and network equipment; 3 to 7 years for other equipment; and 10 to 40 years for buildings and improvements. Similarly, WorldCom's 2001 annual report states that, for the MCI Group, the useful life for Transmission Equipment is 4 to 10 years; 5 to 10 years for Communications Equipment; and 4 to 39 years for Furniture, Fixtures, Buildings, and Other. For the WorldCom Group, the useful

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3/ Final Arbitration Order, *In the Matter Of AT&T Communications of the Southwest Inc.'s Petition for Arbitration Pursuant to Section 252(b) of the Telecommunications Act of 1996 to Establish an Interconnection Agreement between AT&T Communications of the Southwest, Inc. and GTE Midwest Inc.*, Case No. TO-97-63, Attachment C at 77 (Mo. P.S.C. July 31, 1997) ("*Missouri Order*").

life is 4 to 40 years for Transmission Equipment (including Conduit); 5 to 10 years for Communications Equipment; and 4 to 39 years for Furniture, Fixtures, Buildings, and Other.

Q. HOW DO THE LIVES USED BY CATV OPERATORS COMPARE WITH THE LIVES USED BY VERIZON NW?

A. The lives used by CATV operators are also shorter than Verizon NW's recommended lives. The lives adopted by the FCC for CATV distribution facilities were from 10 to 15 years.[4/] This range was developed from a statistical analysis of lives used by CATV operators for their own facilities. Verizon NW, on the other hand, has recommended a 16 to 18-year economic life for copper cable and a 20-year life for fiber cable, which are longer than the range allowed by the FCC for CATV distribution facilities.

Likewise, the lives proposed by Verizon NW for support assets such as office furniture and equipment, vehicles, and buildings are reasonable when compared to the ranges allowed by the FCC for CATV operators. The FCC/CATV range is 9 to 11 years for office furniture and equipment and 3 to 7 years for vehicles and equipment, which compares favorably to Verizon NW's proposal of 5 to 15 years for these accounts. The FCC/CATV range for buildings

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[4/] Second Report and Order, First Order on Reconsideration, and Further Notice of Proposed Rulemaking, *In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation and Adoption of a Uniform Accounting System for Provision of Regulated Cable Service*, 11 FCC Rcd 2220 (1996).

is 18 to 33 years, which compares favorably to Verizon NW's proposal of 25 years.[5/]

Q. WHAT IS TFI?

A. TFI is an independent research organization, unaffiliated with incumbent local exchange carriers, that specializes in conducting technology/market forecasts. TFI forecasts the remaining lives for certain telecommunications assets due to technological change and competition. To quantify the technological change, TFI uses a model to analyze remaining economic lives using patterns of technological substitution observed in the communications industry and other industries. To quantify the competitive change, TFI analyzes the impact of expected changes in customer demand on the economic value of the telecommunications assets. This change in economic value is then translated into a useful life impact. A 2001 TFI study forecasts that the local exchange network will continue to modernize and evolve, and that by 2015 only about 10% of the equipment in the local exchange network that was in place at the turn of the century will still be in use.[6/]

Q. HOW DO THE LIVES THAT VERIZON NW USES IN THE UNE COST STUDIES COMPARE WITH TFI'S RECOMMENDED ECONOMIC LIFE RANGES?

5/ *See id.*

6/ LARRY K. VANSTON, TECHNOLOGY FUTURES INC., THE LOCAL EXCHANGE NETWORK IN 2015, Telecom & Technology Reports (2001) (reproduced at www.tfi.com).

A. The economic lives in Verizon NW's UNE cost studies fall within TFI's recommended economic life ranges, as shown by the following:[7/]

	TFI Recommended	2003 Verizon Cost Studies
Digital Switching	9-12	12
Digital Circuit	7-9	9
Metallic Cable	10-20	16-18
Non-Metallic Cable	15-20	20

V. VERIZON'S ECONOMIC LIVES HAVE BEEN ENDORSED BY OTHER STATE REGULATORY COMMISSIONS.

Q. HAVE OTHER STATE COMMISSIONS ADOPTED THE DEPRECIATION LIVES RECOMMENDED BY VERIZON?

A. Yes. A number of states have adopted the GAAP lives that Verizon proposes here. Most recently, the Public Service Commission of the District of Columbia adopted Verizon's economic depreciation lives.[8/] The D.C. Commission deemed these lives "TELRIC-compliant,"[9/] stating that "[b]ecause GAAP is more current than the FCC's depreciation lives, we deem GAAP more forward looking than the FCC's projection lives . . . ."[10/] The California Public Utilities Commission ("CPUC") endorsed the use of the economic lives used by Pacific Bell for

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7/ LAWRENCE K. VANSTON & RAY L. HODGES, TRANSFORMING THE LOCAL EXCHANGE NETWORK: REVIEW AND UPDATE tbl. 1.2 P. 5 (Technology Futures, Inc. 2003).

8/ 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).

9/ *Id.* ¶ 333.

10/ *Id.* ¶ 334.

external financial reporting purposes as the appropriate forward-looking lives for UNE cost studies, and correspondingly rejected the suggestion by AT&T and others that FCC-prescribed lives are forward-looking. Specifically, the CPUC stated that Pacific Bell used these lives "in financial reports it is required to file, and thus for purposes of these cost studies, the schedules also appear consistent with generally accepted accounting principles."[11/] The CPUC continued, "The schedules also appear realistic for a firm having to operate in a competitive environment, as Pacific will soon have to do. Accordingly, we will approve their use in this proceeding."[12/] Correspondingly, the CPUC rejected the use of lives developed for regulatory accounting purposes, stating, "We agree with Pacific that the schedules formally adopted in the represcription proceeding reflect the previous paradigm of the regulated monopoly environment, and so are difficult to justify in a cost study that looks forward to an environment in which there is local exchange competition."[13/] Commissions in Michigan and Missouri have also found that the financial reporting lives recommended by Verizon are

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11/ Rulemaking on the Commission's Own Motion to Govern Open Access to Bottleneck Services and Establish a Framework for Network Architecture Development of Dominant Carrier Networks and Investigation on the Commission's Own Motion into Open Access and Network Architecture Development of Dominant Carrier Networks, Rulemaking No. 93-04-003 and Investigation No. 93-04-002, Interim Opinion Adopting in Part and Ordering Modifications to Round I and II Cost Studies Submitted by Pacific Bell and GTE California, Decision No. 96-08-021, at 77 (Cal. P.U.C. August 2, 1996).

12/ *Id.*

13/ *Id.*

the most appropriate for determining UNE rates.[14/] Additionally, in recent cases under section 271 of the Act, the FCC approved the use of GAAP lives by SBC (in Kansas and Oklahoma) and by Verizon (in Pennsylvania).[15/] But as noted above, the Washington Commission has yet to adopt GAAP lives.

VI. CONCLUSION.

Q. PLEASE SUMMARIZE YOUR DIRECT TESTIMONY.

A. The economic lives used in Verizon NW's proposed cost studies are properly based on a forward-looking approach. Verizon NW has used the same depreciation inputs used for financial reporting to shareholders and the same inputs filed with this Commission and approved for financial reporting purposes. Verizon NW's proposed depreciation inputs should be adopted for use in the UNE cost studies.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.

[14/] *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).

[15//] Memorandum Opinion and Order, *In the Matter of Joint Application by SBC Communications Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance for Provision of In-Region, InterLATA Services in Kansas and Oklahoma*, 16 FCC Rcd 6237, 6274 ¶ 76 (2001); *see also* Reply Declaration of Daniel J. Whelan and Gary E. Sanford, *Application by Verizon Pennsylvania Inc. et al. for Authorization to Provide In-Region, InterLATA Services in Pennsylvania*, FCC 01-269 CC Docket No. 01-138, at 16-18 (August 2001).