Depreciation Policies of Other Carriers

Q. Let's turn to the fourth section of your testimony, concerning the depreciation policies of other carriers. Would you briefly discuss the data US West previously submitted concerning depreciation rates and lives of its competitors?

A. On June 15, 1998, US West witness Easton presented an analysis of the depreciation lives prescribed for AT&T by the FCC, and the lives used by four other companies that he considered to be competing with US West.[1] Mr. Easton acknowledged that depreciation lives of unregulated companies are hard to come by, but he somehow obtained information regarding the lives used by these particular carriers.

Next, Mr. Easton presented an analysis regarding lives used by other "potential competitors." Specifically, Mr. Easton relied upon a January 29, 1996 FCC order regarding the depreciation lives to be used by cable television companies. Apparently, the lives presented in this FCC order were based upon lives used by cable companies for financial reporting purposes. Since cable companies do not deploy the same plant and equipment as LECs, Mr. Easton attempted to "translate" the cable company data for comparison purposes. For example, Mr. Easton equated cable headend equipment with telephone circuit equipment. Similarly, Mr. Easton compared cable transmission equipment to telephone fiber plant.

For certain plant accounts, Mr. Easton also compared US West's proposed lives to the lives allowed by the IRS for tax purposes. According to Mr. Easton, these lives are sometimes used by companies for financial reporting in lieu of performing detailed depreciation studies. Finally, Mr. Easton examined composite depreciation rates used by AT&T, MCI and Metropolitan Fiber System (MFS). The data presented by Mr. Easton was also relied upon by US West witness Kerry Wu, in his March 19, 1999 testimony.

Q. Has the Commission commented on the competitor data provided by US West?

A. Yes. In its September 17, 1999 Order, the Commission rejected the US West proposal,

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[1] Electric Lightwave Inc., AT&T/TCG, Phoenix Fiber and McLeodUSA Inc.

because it was based upon an "inappropriate" analysis of the "mid-range" lives of these competitors. The Commission explained its reasoning as follows:

> the "competitors" chosen as comparisons are inappropriate because they do not include at least six of the Arizona facilities-based companies that are certificated in Arizona, but included IXCs and cable companies that are not as capital intensive; the lives of the other carriers were not weighted to account for investment levels and not actually recovering depreciation; the use of an out of state carrier's undocumented projection life for digital switches which results in a $28 million increase for Arizona ratepayers; the use of financial book lives and Internal Revenue Service tax recovery lives to determine regulatory depreciation levels. [p. 7]

Q. Is data readily available regarding other carriers' depreciation practices?

A. Yes, a limited amount of financial data is available for all publicly traded companies, including the CLECs that compete with US West. In particular, publicly traded companies are required to file 10Ks (Annual Reports) with the Securities and Exchange Commission (SEC). These 10Ks are the single best, most consistent source of financial data for CLECs. Unfortunately, there are several problems with this data source.

First, many carriers do not publish the specific lives they are using in computing their depreciation expense. Even when lives are reported on the 10K, there is rarely enough detail to be fully useful. For example, a carrier may report life ranges for two or three groups of plant, but the categories tend to be very broad. For instance, a carrier might report that it is using depreciation lives of 5-20 years for the category "telecommunications network". Rarely, if ever, do 10Ks include detailed enough information concerning depreciation lives to provide a useful comparison with each of the seven accounts that remain at issue in this proceeding.

Second, although all carriers include depreciation data on their balance sheets and income statements, this data is typically reported with a high level of aggregation. For instance, depreciation expense is typically reported at the total company level, and may not be disaggregated into individual plant accounts analogous to the seven accounts that remain in dispute in this proceeding. Similarly, depreciation expense is often combined with amortization expense. Thus, for many carriers one can only glean an understanding of their depreciation

policies in conjunction with their policies concerning amortization of various capital accounts.

Third, investment data is usually disaggregated into only a handful of categories, such as plant and equipment, intangible assets, and "other" assets. Here again, the available data is not nearly as detailed as the information which is available for the Regional Bell Operating Companies, like US West. Thus, it is difficult to evaluate the extent to which the capital investments of particular carriers are comparable to the seven remaining accounts.

Despite these problems, I recommend relying upon 10Ks if the Commission wants to evaluate the depreciation practices of US West's competitors or other unregulated carriers. I am not aware of any other public source of data for unregulated telecommunications carriers which is as reliable, or as readily available for a large cross section of carriers. Drawing upon the financial information published in the 10Ks, it is feasible to look at the depreciation practices of a reasonably large group of other carriers, knowing that the information for most, if not all, of the carriers is reasonably consistent and reliable, since it is included in an official report submitted to the SEC, and it is the type of information which is routinely relied upon by investors.

Q. Have you assembled this type of data from the 10Ks filed by US West's competitors?

A. Yes. I reviewed US West testimony in this and other proceedings before the Commission, to identify companies that US West considers to be its competitors. In addition, I used an article in a trade publication (X-CHANGE magazine) which discusses competitive conditions in Arizona, and includes a list of 16 major carriers operating in the state. [X-CHANGE, August, 1999, p. 44]. This allowed me to identify more than 20 CLECs that appear to be operating in Arizona. I then narrowed the list by eliminating companies for which 10Ks were not available (presumably because they are not publically traded). Also, I eliminated McLeodUSA because it apparently does not have a significant presence in Arizona, as noted by the Commission. [Opinion and Order, September 17, 1999, footnote 2]. The remaining 18 companies are listed on Schedule 4. I then analyzed the depreciation and amortization data which is included in the 1998 10Ks for all 18 of these companies. I found that seven of the companies reported depreciation separately from amortization. Accordingly, for these seven companies I also analyzed

depreciation expenses excluding amortization.

Q. What conclusion did you reach concerning the capital recovery policies of the seven companies which separately report depreciation expense?

A. Although the specific situation varies for each firm, there is no basis for concluding that these seven carriers are consistently recovering their investment in net plant and equipment more rapidly than US West. To the contrary, it is fair to say that the overall pace at which these carriers are depreciating their investment in plant and equipment is not greatly different than that of US West.

In arriving at this conclusion, I divided their 1998 depreciation expense by an average of their 1998 beginning and ending year balances for net plant. This provided a reasonably consistent picture of how rapidly these firms are recovering (writing off) their existing (net) investment in plant and equipment. The results of this analysis are provided in Table 4 below. As shown, their depreciation ratios range from 5.9% to 30.6%. The simple average is 15.0%; weighted by investment, the average is 14.4%. This implies that, on average, these seven firms will recover their existing investment in plant and equipment over the next 6 - 7 years.

Table 4

Competitor Depreciation Ratios

Companies	Depreciation Ratio
Advanced Radio Telecom Corp.	10.6%
Convergent Communications, Inc.	30.6%
Cox Communications, Inc.	16.1%
Frontier Corp.	13.9%
GST Telecommunications, Inc.	5.9%
Intermedia Communications Inc.	17.0%
Nextlink Communications, Inc.	10.8%
Simple Average	15.0%
Weighted Average	14.4%

Q. Can you be more specific concerning the US West side of your comparison?

A. Yes. I began with US West's existing deprecation expense and adjusted it for the impact of depreciation changes which have already been adopted by the Commission in this proceeding, as well as the potential effect of the three different scenarios for the remaining seven accounts, as summarized in Table 5. The first scenario includes a $29.2 million depreciation expense increase, based upon Staff's inputs. It results in an overall depreciation ratio of 15.5%. This is slightly higher than the average for the seven competitors.

The second scenario includes a $14.4 million depreciation expense increase, based upon the low end of the generic FCC lives for these seven accounts. This results in an overall depreciation ratio of 14.7%, which is very similar to the average for the seven competitors (their simple average is 15.0% and their weighted average is 14.4%).

The third scenario illustrates what would happen if the Commission were to adopt depreciation lives for the seven remaining accounts at the high end of the generic FCC ranges. In that case, US West's depreciation ratio would drop to 13.2%, which would be somewhat lower than the average for the seven competitors.

Table 5

US West Depreciation Ratios

Scenario	Depreciation Ratio
Staff Inputs	15.5%
FCC Low	14.7%
FCC High	13.2%

Q. You mentioned that many firms only report depreciation expense combined with amortization expense. Have you prepared any calculations using this combined measure of capital recovery for these seven competitive carriers?

A. Yes. I calculated a broad measure of the rate at which these seven companies are recovering their total invested capital. Specifically, I divided depreciation and amortization expense by the average of their 1998 beginning and ending year total assets (the total of the left side of their balance sheet).

The results of this calculation are also summarized in Table 6 below. As shown, the ratio ranges from 3.0% to 9.3%. The simple average is 5.5% and the weighted average is 5.7%. This indicates that these seven firms will recover their existing investment (including all of the assets on the left side of their balance sheet) over the next 17 to 19 years.

Table 6

Companies	Depreciation and Amortization Ratio
Advanced Radio Telecom Corp.	3.0%
Convergent Communications, Inc.	7.1%
Cox Communications, Inc.	4.7%
Frontier Corp.	8.1%
GST Telecommunications, Inc.	4.5%
Intermedia Communications Inc.	9.3%
Nextlink Communications, Inc.	3.3%
Simple Average	5.5%
Weighted Average	5.7%

For comparison purposes, I have used the same three scenarios for US West. As shown in Table 7, using Staff inputs, FCC low lives and FCC high lives results in depreciation and amortization ratios of 12.4%, 11.7% and 10.5%, respectively. All of these ratios are higher than the corresponding averages for the seven competitors. The discrepancy is primarily caused by the fact that these competitors all have substantial investments in FCC licenses and other assets which they are amortizing over relatively long periods of time. In contrast, US West's balance sheet is not weighted down with substantial investments of this type; nearly all of its capital is invested in plant and equipment which it is depreciating over relatively short periods of time.

Table 7

Scenario	Depreciation and Amortization Ratio
Staff Inputs	12.4%
FCC Low	11.7%
FCC High	10.5%

Q. Do your conclusions differ for the entire group of competitors, including those which don't separately report depreciation expense?

A. No. As shown on Schedule 4 of my exhibit, the results for the entire group tend to be similar to the results for the seven companies discussed up to this point. For the larger group a separate depreciation ratio cannot be computed, but the overall capital recovery ratio ranges from 2.1% to 10.5%. The simple average is 5.5% and the weighted average is 6.5%. This data indicates that, on average these eighteen firms will recover their existing investment (including all of the assets on the left side of their balance sheet) over the next 15 to 18 years.

While the pace of capital recovery differs for each firm, it is fair to say that none of these carriers is recovering its total capital substantially faster than US West. To the contrary, the data suggests that US West is writing off its Arizona assets more quickly than most of these carriers are writing off their assets.

Q. Your analysis seems to indicate that even if the Commission were to use the low end of the FCC ranges for the seven remaining accounts, US West would be recovering its capital faster than most of its competitors. Is that true?

A. Yes. It is fair to conclude that US West would not be placed at a competitive disadvantage if the Commission were to adopt lives which are at the low end of the FCC ranges for the remaining seven accounts. While a slightly different conclusion might be reached for some accounts and/or some competitors, the overall pattern is clear: the Commission can adopt lives at the low end of the FCC range without placing US West at a serious competitive disadvantage.

To the contrary, most of the competitive carriers have substantial investments in assets (like FCC licenses) which they are recovering over very lengthy periods of time. Thus, their overall pace of capital recovery is actually quite a bit slower than that of US West, and this will remain true even if the Commission were to adopt lives at the high end of the FCC ranges for the remaining accounts.

Q. Are you suggesting that the Commission should adjust US West's depreciation rates to

match those of its competitors?

A. No. Capital recovery rates should be appropriate to the situation of a particular carrier, and should continue to take into account the historic experience of that carrier, as well as the specific economic factors affecting that carrier.

The Commission has asked the parties to provide evidence concerning the capital recovery policies of competitive carriers, but I don't believe this data should exclusively determine the outcome of this proceeding. As it happens, the data indicates that US West is recovering its capital investment more quickly than other carriers. But even it the opposite were true, I don't believe this would compel a substantial increase in US West's depreciation expense. The capital recovery policies of other carriers can differ for many reasons, and this data should not be the controlling factor which ultimately determines the Commission's decision in this proceeding.

In any event, comparisons with unregulated, competitive companies should viewed with caution. None of the firms competing in Arizona are fully comparable to US West, in terms of the size and scope of their operations, the technologies they rely upon, and the assets that they own. For instance, the list of competitors included in Schedule 4 includes one cable television company, several carriers that are predominantly long distance carriers, and others that primarily rely upon wireless technology. The Commission has already recognized that cable companies and IXC's are generally less capital intensive than LEC's. While wireless carriers can be quite capital intensive, their capital is often invested in licenses, radio towers, and other items which are different from the items included in the accounts remaining in dispute in this proceeding.

Moreover, although these carriers may provide services which compete directly with those offered by US West, they don't necessarily rely upon the same mix of assets, and their mix of services may be different than that of US West. A firm like MCI Worldcom, for example, provides both local and long distance telephone service, as well as local access and long haul (backbone) Internet services. Finally, some of these competitors have only been in business a few years, and therefore have newer, less depreciated plant then US West. Whether their current capital recovery practices will prove adequate remains to be seen. I question

whether it would be wise to adjust US West's capital recovery policies to match those of smaller, new firms. The latter firms are basing their depreciation and amortization policies upon a very limited range of historic experience, and are forced to rely heavily on inherently speculative projections concerning customer demand, technology and other factors, and yet they have very limited historic experience which they can draw upon in developing these sorts of projections.

Q. Are there other comparisons which could be useful to the Commission?

A. Yes. I recommend that the Commission also look at the capital recovery policies of other incumbent local exchange carriers. Although they may not operate in Arizona, these carriers are otherwise quite similar to US West.

Q. Have you prepared any comparisons with these other LECs?

A. Yes. The most comparable companies to US West are obviously the RBOCs and other regulated LECs. I have used data reported in the FCC's 1998 Statistics of Communications Common Carriers (SOCC) to calculate average depreciation rates for all reporting RBOCs, other (non-RBOC) reporting LECs, and all reporting LECs. The latter group includes both RBOCs and non-RBOCs. The results are presented on Schedule 5. Page one shows balance sheet accounts and depreciation and amortization expenses for these three groups of LECs. Page 2 shows the composite depreciation and total capital recovery ratios for these three groups, and compares them to the rates for US West using the same three scenarios discussed earlier.

As shown on page 2 of Schedule 5, the composite depreciation rates for the RBOCs, Other Reporting LECs and All Reporting LECs are 13.5%, 13.8% and 13.6%, respectively. These ratios are lower than the corresponding ratios for US West that would result from adoption either of the Staff inputs or the low end of the FCC lives for the remaining accounts in dispute. They are only slightly higher than the US West ratio that would result if the Commission were to use the high end of the FCC lives for these accounts. A similar pattern occurs when one compares total capital recovery rates. These results show that using lives towards the low

end of the FCC generic ranges for the seven remaining accounts will allow US West to recover its total capital investment at a pace that is comparable to, or slightly faster than, other LECs.

Q. US West Witness Kerry Wu has argued that lives are more important than rates, when comparing US West to other companies. Do you agree?

A. No. Data concerning both lives and rates of capital recovery can be useful in the context of this proceeding. Capital recovery rates (like those discussed above) enable the Commission to compare how rapidly US West will be allowed to recover (write off) its capital, relative to the pace at which other companies are recovering (writing off) their capital. Also, capital recovery ratios capture the net impact of numerous different factors, such as whether a firm uses ELG or whole life depreciation, whether or not it is amortizing any reserve deficiencies, what survivor curves it is using, and whether it is assuming positive or negative net salvage. If one looks at lives alone, one doesn't take into account all of these different factors, which ultimately impact the amount of depreciation expense, and thus the speed with which a firm is recovering its capital investment.

That is not to say that depreciation lives are completely irrelevant. In particular, a comparison with the lives adopted by the FCC or state regulators in other jurisdictions can be useful in providing a benchmark against which the Commission can compare its judgment concerning individual accounts.

Q. Do you have any evidence to present regarding lives used by other local exchange carriers?

A. Yes. As I explained earlier, there is very little public data available regarding the lives used by unregulated carriers. However, data is available for the RBOCs. This is particularly useful, because it provides an indication of the lives which have been approved by regulators in other jurisdictions for carriers which are similarly situated to US West. Schedule 6 shows the FCC prescribed lives for Ameritech, Bell Atlantic, Bell South, SBC and US West. Data for each RBOC appears on a separate page. Each page shows FCC prescribed lives for the seven remaining accounts, for each state in which the RBOC operates. In many cases, these are the

same lives adopted by the state regulatory commissions, because matching lives are often set by agreement between the FCC and the respective state commission. For comparison purpose, I also have presented data on lives that other state commissions have approved for US West. This data is presented on Schedule 7.