

SWBT's Response to the MiCRA Report

MiCRA prepared a report, titled Depreciation Policy in the Telecommunications Industry: Implications for Cost Recovery by the Local Exchange Carriers, on behalf of MCI. Simply stated, MiCRA concludes that FCC regulation has not caused under-depreciation of the LECs' assets and the LECs do not have a depreciation problem. The MiCRA report, however, is inaccurate, superficial, and misleading. In fact, the LECs' regulated depreciation lives are too long, their regulated reserves are deficient, their regulated depreciation expense has been understated, and, as a consequence, their past earnings have been over-stated, all because of the past regulation of depreciation.

The theoretical reserve as an indication of a depreciation problem.

As a means of determining the existence of a LEC depreciation problem, MiCRA calculates a "theoretical reserve" amount for the major LECs.¹ MiCRA simplistically concludes that, since MiCRA's theoretical reserve calculations show no significant reserve deficiency (when compared to the LECs' book reserves), then there is obviously no depreciation problem. This could appear to be a convincing argument, if only it were not based on totally wrong assumptions and circular logic.

The theoretical reserve is simply a calculated amount of reserve that would have existed on the LECs' books today if the "current" life and salvage parameters had been in place since the beginning.² By far, the most critical components of this calculation are the lives.

MiCRA assumes that the appropriate lives to be used in the theoretical reserve calculation are those currently prescribed by the FCC. Using the FCC's currently-prescribed lives in its calculation, and comparing the result to the LECs' book reserves, MiCRA determines a theoretical reserve deficiency of only about \$3 billion for the major LECs. MiCRA then concludes, based on this calculation, that the LECs have no depreciation problem (i.e., that the regulatory lives have been adequate for the LECs).

¹ MiCRA omits the following price cap LECs from its analysis: GTE, Sprint, LTD, SNET, Lincoln and Frontier.

² "Current" in this sense does not necessarily mean proper.

However, it is these very lives that cause MiCRA's calculation of the theoretical reserve deficiency to be as low as it is. In other words, MiCRA assumes that the FCC's lives are correct in order to prove that the FCC's lives are correct. Therefore, MiCRA's approach is circular logic, and proves nothing. Hence, MiCRA's conclusion is erroneous. In fact, these regulatory lives are precisely the cause of the LECs' depreciation problem.

Also, MiCRA refers to the fact that its calculations are corroborated by the LECs' own theoretical reserve calculations filed annually with the FCC. Either MiCRA is unaware, or chooses not to point out, that the FCC requires these annual filings to be based on the FCC's prescribed lives, not the lives the LECs believe to be proper. Thus, MiCRA has proved nothing.

Further, MiCRA refers to a similarly "insignificant" \$5 billion theoretical reserve deficiency for the LECs, based on life proposals made by the LECs to the FCC during the period from 1992 to 1994. In this instance, MiCRA assumes that the LECs' life proposals have not changed from those submitted in the 1992-1994 time-frame. However, this is also an invalid assumption. Much has changed in the telecommunication industry even since 1992. More regulatory and legislative measures promoting competition have emerged since 1992. More technology advances have occurred since 1992. If MiCRA had wanted to use a period of time more representative of the LECs' current views of their assets' lives, they would have chosen the last couple of years, during which most all major LECs evaluated their depreciation problems in connection with the discontinuance of FAS 71 for external financial reporting.

Regulatory-prescribed lives have historically been too long.

Regulatory lives have consistently been overstated. Even the FCC's past actions have clearly acknowledged this problem. For example, in the mid-1980s, the FCC recognized that even their recently-adopted remaining life depreciation method would not eliminate the LECs' reserve deficiencies that had been built up by inadequate lives and methods, in a timely manner. Unfortunately, when the FCC allowed the LECs to amortize this reserve deficiency over five years, it understated the size of the deficiency by using the lives prescribed at that time to calculate a theoretical reserve level.

The FCC also recognized that past lives sometimes create significant reserve imbalances as the corresponding plant balances approach zero. To remedy this type

of situation, the FCC adopted special procedures for "dying accounts"³. The most obvious example of the LECs' past need for this type of remedy was in electromechanical switching. Both the LECs' life proposals and the FCC's life prescriptions for electromechanical switching did not properly predict the eventual rapid displacement of this technology. Had the demise of electromechanical switching been recognized early enough, then the extraordinary effort to catch-up the reserves (i.e., the amortization of the reserve deficiencies for these dying accounts) would not have been required.

Further evidence of the FCC's acknowledgment that past lives have been too long is their acceptance of somewhat shorter lives in the last few years. However, even these shorter lives are generally much longer than those proposed by the LECs. Since the FCC has not accepted the LECs' shorter life proposals, which more accurately and more realistically reflect the usefulness of their plant in the current environment, it is highly likely that dying account amortization will also be required in the future. However, even though this type of procedure was somewhat more acceptable in the industry in the past, these extraordinary, and often after-the-fact, reserve catch-ups are not appropriate in the competitive environment of today and the future, since they unfairly disadvantage the LECs.

The remaining life method of depreciation does not solve the LECs' reserve problems.

The MiCRA report claims that problems simply do not and will not exist in the LECs' reserves, because of the FCC's adoption of the "remaining life" depreciation method. It should be immediately acknowledged that the remaining life method is far superior to the FCC's prior "whole life" method. Under whole life, any reduction in prescribed life would cause future depreciation accruals to reflect the new life, but nothing was done to compensate for all of the past under-accruals caused by the old overstated life (or lives). Remaining life, on the other hand, builds this compensation or catch-up into the future accruals. Therefore, its self-correcting nature is a vast improvement over whole life. However, even remaining life is plagued by two faults:

- Remaining life only corrects (in the future) those changes in lives that have already occurred. It does not anticipate future changes in lives and the further accrual corrections that those future life changes will require. Thus, remaining life is only a reactive method, not proactive. This is critical because: (a) history has shown that the FCC's past life prescriptions have been too long (therefore, requiring subsequent, but much too gradual, life reductions and/or

³ Dying account amortization was introduced by the FCC in its 1983 triennial represcription Order, FCC 83-587, starting at paragraph 42.

special dying account amortization to dispose of the associated reserve deficiencies); and (b) it is reasonable to expect the FCC to have to make further life reductions in the future.

- Even for a life reduction that has already occurred, and for which remaining life is already compensating, remaining life will not achieve the needed catch-up in the reserve until the very end of the life of the account. This catch-up period could be much longer than is reasonable for the LECs' assets to be properly reserved. For example, based on lives presently prescribed by the FCC, this catch-up period is as much as 10 to 15 years into the future for copper cable. This is significantly longer than the catch-up period associated with the simple example of remaining life in the MiCRA report.

Shorter asset lives are appropriate for SWBT and the other LECs now.

The LECs use several forecasting techniques to predict the lives of their major asset categories. These include life cycle, technology substitution, and other forms of analyses. The LECs' life forecasts are generally consistent not only with each other, but also with the studies prepared by Technology Futures, Inc. (TFI). The TFI studies use past and present evidence of the actual substitution of older technologies by newer technologies to forecast the lives of the LECs' present assets. The TFI studies also address the impact of competition on the cash flows that the LECs' present networks can be reasonably expected to generate in future years (and hence, the impact of competition on the useful lives of these network assets). TFI's studies are described further in an attachment to USTA's Reply Comments in the immediate proceeding. SWBT fully supports the USTA Reply Comments and the TFI study entitled "Implications of Technology Change and Competition on the Depreciation Requirements of the Local Exchange Carriers," included there as Attachment D.

One of the most relevant aspects of the LECs' analyses and TFI's studies is the distinction between the physical retirements of assets and the usefulness of those same assets. The FCC has placed considerable reliance on the LECs' historical retirements, as well as their budgeted retirements three years into the future, to prescribe lives. The LECs and TFI, on the other hand, determine more-realistic lives by assessing the future usefulness of the assets, based not on physical retirements, but instead, on such factors as the pace of customers' migration off of those assets, the future cash flows which can be generated by those assets, and the actual substitution of newer technologies for those older assets. This important distinction between physical retirements and future usefulness recognizes, for example, that all large copper cables may: (a) gradually lose the use of their pairs over the next ten to fifteen years; and (b) not be physically retired until ten to fifteen years from now. Lives improperly determined by physical retirements incorrectly appear to be very

long until the last few years, even though the economic usefulness of assets has been declining throughout the entire period. Conversely, lives properly determined by recognizing now this gradual loss of usefulness allow the depreciation of the assets to be fast enough to achieve full depreciation by the end of the assets' useful lives.

Whereas the LECs and TFI have performed forecasts of the lives of the LECs' assets for many years, MiCRA did not undertake any analysis to determine what lives the LECs should be using. Instead, MiCRA improperly assumed the FCC's presently-prescribed lives were correct. Of course, doing so incorrectly (and circularly) gives them the result they desire.

Additional evidence on the shorter lives that should be used by the LECs comes from the recent actions taken by most of the major LECs to discontinue the application of FAS 71 for external financial reporting. SWBT developed estimates of the useful lives of its plant, using not only TFI's industry studies, but also the strategies and plans specific to SWBT. Generally Accepted Accounting Principles (GAAP) require businesses to accurately record and report the depreciation of their assets. SWBT has complied with these GAAP requirements, as attested to by its external auditors. Furthermore, SWBT's estimates of GAAP lives are consistent with those resulting from the other major LECs' analyses.

Even further evidence that SWBT's depreciation lives should be shorter is a comparison between the ranges of lives prescribed by the FCC for the LECs with the ranges of lives recently prescribed by the FCC for the cable TV companies. It is inconceivable that the same federal agency could determine that the lives for like types of assets could be longer for the LECs than for the cable TV companies. It is certainly clear that the cable TV companies are already preparing for direct competition with the LECs in the basic telephone service markets (through consolidations, upgrading of older plant, etc.). Also, the recently-passed Telecommunication Act of 1996 confirms the fact that LECs and cable TV companies will be competing head-to-head in the local telecommunications markets. Therefore, competitors in the same markets, and using similar assets, should be allowed to depreciate those assets using similar lives.

Additional inconsistency in the FCC's prescriptions of depreciation lives can be seen by comparing the lives prescribed for the LECs with those prescribed for AT&T. Even though the depreciation flexibility granted to AT&T by the FCC is warranted so that AT&T can fairly compete with other companies in the interexchange telecommunications market, it is likewise inconceivable that the FCC would distinguish between the LECs' depreciation and AT&T's depreciation (or, for that matter, any other interexchange carrier's self-prescribed depreciation), because all of

the major IXCs have taken clear steps to prepare for entry into the local telecommunications markets to compete head-to-head with SWBT and the other LECs.

MiCRA's allegation that the LECs have an improper motive for more rapidly depreciating their existing networks is wrong.

The LECs correctly insist that they need shorter depreciation lives than those presently prescribed by the FCC. This is simply because SWBT's and the other LECs' existing plant must be depreciated more rapidly right now.

It is true that the LECs' present networks have been put in place over many years principally for providing basic telephone services. It is likewise true that most of the LECs' customers currently use only basic telephone services. However, there are two principal reasons the LECs will not have the opportunity to recover their present networks by providing these same basic services to these same customers using these same old assets in the future.

First, more and more of the LECs' basic telephone customers are demanding more-sophisticated, more-reliable, higher-bandwidth services today. As well, the LECs' networks must also evolve to meet these customer demands.

Second, the growth of competition in the LECs' basic telephone service markets will literally take present customers away from the LECs. These types of customers will switch from an incumbent LEC to a competitor such as a wireless telecommunications provider (cellular, PCS, or DBS), or a cable TV system providing packaged telephony and video.

The bottom-line here is that these two factors will cause the LECs to have a significant amount of older-technology plant for which there are few, if any, customers, or over which no services can be provided. If depreciable assets cannot be used to provide services to customers (i.e., if it has no remaining usefulness), then it will not generate revenue for the LECs.

The ability of depreciable assets to generate revenue is a critical business issue. It is obvious that no business can survive for long by absorbing the costs of operations or assets during a period of time in which those operations or assets generate no customer revenue to cover those costs. Thus, it is an elementary accounting concept that the cost of an asset be charged to expenses rateably over the period for which the asset can generate revenue for the business. Therefore, the LECs must depreciate their assets over the period of time for which those assets can realistically be expected to generate revenue. That means that the slow depreciation prescribed by the regulators in the past is not proper today.

MiCRA incorrectly claims this basic accounting principle is a LEC ruse for using current customers of basic telephone services to finance the replacement of their present networks with new networks capable of providing "new non-telephony services."⁴ This accusation is patently wrong for several reasons:

- As described above, even the LECs' present customers are demanding bandwidth and reliability which require the LECs to deploy the latest-technology plant now.
- Depreciation of today's assets is not the gathering of customers' money to finance future deployment of newer plant. Instead, it is a repayment from today's customers to the owners of the business that contributed the original capital to buy the present plant. Even the National Association of Regulatory Utility Commissioners (of which the FCC is a prominent member) says in its depreciation manual,

"Depreciation accounting is the process of charging the book cost of depreciable property to operations over its life. ... The purpose is not, as many people erroneously think, to finance replacements."⁵

In addition, there are two similar cites from the Iowa State text on depreciation, one of the definitive academic references on depreciation:

"The sole purpose of depreciation cost accounting is to recover the depreciable cost of the property through charges to production cost. Obviously, such an objective is totally unrelated to replacement cost as well as to replacement. Depreciation cost accounting is not for the purpose of building up a fund for replacement of property."⁶

"Although the capital invested in depreciable assets may be recovered, it is not necessarily preserved in the business. After the cost of an asset is recovered, management has the responsibility and freedom to use the funds in accordance with its best judgment."⁷

⁴ MiCRA report, page 20.

⁵ Public Utility Depreciation Practices; National Association of Regulatory Utility Commissioners (1968); page 82, section 2.a.

⁶ Engineering Valuation and Depreciation; Marston, Winfrey, and Hempstead (1953); page 182, section 8.6

⁷ Id., page 183, section 8.7

Clearly, MiCRA disregards the real purpose of depreciation, and the real "owner" of the LECs' depreciation expense.

- MCI and MiCRA imply that the LECs should be relegated to the provision of basic telephone services and to the technologies of the past. However, even MCI, as a SWBT customer, continues to press SWBT to provide the latest network capabilities. Furthermore, there are numerous present and future competitors of SWBT and the other LECs who are modernizing networks, acquiring others' networks, building new networks, all to become full-service providers of the full spectrum of telephone services, video services, high-bandwidth data services and other communications and information services. This is certainly MCI's intent through MCI metro and its other business arrangements. Therefore, SWBT and the other incumbent LECs must not be relegated to providing only narrow-bandwidth, basic telephone services in the future, with their existing, under-depreciated networks. In addition, MCI and the LECs' other competitors must not be allowed to gain and maintain unfair advantage over the LECs through the regulators' out-of-date depreciation lives and methods.

Conclusion

As explained by SWBT in this attachment, MiCRA's conclusions are wrong. MiCRA completely ignores the changes occurring in the telecommunications industry. In fact, MiCRA performs no analysis of the accuracy or the realism of the FCC prescribed lives. Instead, MiCRA's use of the FCC prescribed lives results in circular logic and flawed conclusions regarding the LECs' depreciation. Thus, the FCC must totally disregard MiCRA's report.

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of)
)
Price Cap Performance Review) CC Docket No. 94-1
for Local Exchange Carriers)
)

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would be based on access lines per square mile of serving territory. This criterion is simple, uses publicly available data, and clearly measures the density characteristics of individual LEC serving areas. Assignment of a productivity factor is also clear: LECs whose access lines per square mile are less than or equal to approximately 75 to 80% of the average number of access lines per square mile would use the lower productivity factor; all other LECs would use the higher productivity factor.³¹

VI. U S WEST RESPONDS TO ISSUES IDENTIFIED BY
THE VARIOUS COMMENTERS IN THIS PROCEEDING

A. Commission Prescribed Depreciation Rates
Are Not Appropriate Inputs For TFP Calculation

MCI Communications Corporation ("MCI") asserts that prescribed depreciation rates are the appropriate inputs for TFP calculation. In support of their assertion, MCI cites a Baseman and Van Gieson ("B&VG") study which they argue indicates that the Commission's current policy for setting depreciation rates has not led to a significant overvaluation of assets (as measured by the existence of reserve deficiencies), and thus adequately reflects the economic life of plant.³²

³¹ Of course the Commission could choose to use as a threshold a specific number of access lines per square mile based on the natural division between the two types of companies, high density and low density.

³² Comments of MCI, filed herein Jan. 11, 1996 at 18.

This argument is circular. Mathematically, the amount of reserve deficiency is determined by assumptions concerning expected life. If, for example, one were to double the prescribed lives of a company's assets and use these revised lives to calculate a reserve deficiency, there would not be a calculated reserve deficiency; in fact, there would be a considerable surplus. Using MCI's argument, rates based on these lengthened lives would be deemed proper since there would be no reserve deficiency. The obvious fallacy of this argument is that it says nothing about the appropriateness of the underlying lives.

MCI presents no analysis indicating whether the prescribed depreciation lives are appropriate. It is interesting to note that MCI's depreciation rate for 1995 was 8.9%, a rate far in excess of the average prescribed LEC composite depreciation rate of 7.3%.³³ In contrast, the LECs have considerable evidence, as detailed by USTA's Reply Comments filed in this proceeding, that indicates the lives currently prescribed for the LECs do not accurately reflect the realities of today's telecommunications marketplace. Although the Commission has not yet accepted the lives being proposed by the LECs, it has shortened lives in the past several years and has allowed an amortization of the existing reserve deficiency. Both actions implicitly recognize that past prescribed depreciation lives were too long. Further support for shorter lives is demonstrated by the fact that those LECs which have come off the FAS71 accounting standard are now using depreciation lives for Securities and Ex-

³³ USTA Reply Comments at Technology Futures, Inc. Attachment, "Implications of Technology Change and Competition on the Depreciation Requirements of the Local Exchange Carriers," at Table 4 ("TFI Attachment").

change Commission reporting that are far shorter than Commission-prescribed lives.

MCI argues that today's prescribed lives should be the basis for a productivity study that they propose should be updated only every four years. This ignores the fact that depreciation lives are being shortened every year, and that under its Simplification Guidelines, even the Commission will allow an update of lives each year.

B&VG argue that "[t]he existing plant need not be replaced (on an accelerated basis) for efficient provision of basic local telephone services. The RBOCs' proposals for accelerated depreciation would compel users of basic telephone services to subsidize new services that many basic customers may not want."³⁴ This argument ignores the fact that LECs must build integrated telecommunications networks that meet the demands of all classes of customers, including the demands of tomorrow's customers. It is true that there is probably a small group of customers who would be content with rotary dials, cord boards, and multi-party lines, but the vast majority of today's customers have benefited from the advances in technology since the first piece of telecommunications plant was placed in service.

B&VG continue that "[f]urthermore, the FCC's use of remaining life depreciation rates ensures that the large deficits of the early 1980's cannot recur."³⁵ Reserve deficiencies, in fact, will continue to be created as asset life expectations are

³⁴ B&VG Executive Summary at 1.

³⁵ *Id.* at 2.

shortened. Utilizing the remaining-life method provides for the recovery of the deficiency over the remaining life of the assets, in essence shifting the burden of past underdepreciation to future generations of ratepayers. B&VG offer an example of how the remaining-life method shifts costs into future periods, which in reality can be ten to twenty years.³⁶ While this method worked well in the context of a regulated monopoly, this shifting of past costs to the future will prove unworkable in a competitive environment.³⁷

B&VG refer to an Oregon study which they say concludes that copper is always the least-cost technology for the distribution loop and, in most cases, for the feeder portion of the subscriber loop as well.³⁸ It is obvious that the Oregon conclusion was based on "today's" economics, not the economics of the future. Fiber material costs continue to fall, and, as companies move further along the learning curve, installation costs will also decrease. As the outside plant network continues to evolve, with the placement of ever greater amounts of fiber into the feeder and distribution portions of the plant, what is not economical today will become economical tomorrow.

B&VG also argue that local loop reconfiguration does not provide telephony customers with any benefits.³⁹ This argument ignores the reduced maintenance

³⁶ B&VG Study at 7.

³⁷ *Id.* at 17.

³⁸ *Id.* at 17-18 n.24.

³⁹ *Id.* at 18 n.25.

costs and increased reliability fiber will provide in addition to greater bandwidth capability.

B&VG assert that “[g]ranted larger depreciation expense today to finance early retirement of metal and fiber would require basic service customers to subsidize customers of non-basic service.”⁴⁰ As noted above, there is a real issue as to what basic service is now and what it will be in the future. There is no early retirement. Equipment is retired when it is economically and technologically obsolete. For example, electromagnetic switches could be used to provide a form of basic service, but not the level of service that most of our customers expect today. To be a full-service provider, we must upgrade our network to meet the future demands of customers.

Table 20 of the B&VG study compares data from U S WEST’s annual report with “average service life” from U S WEST proposals. This is an “apples and oranges” comparison. The Commission prescribes projection lives, not average service lives. Since U S WEST came off FAS71 in the Fall of 1993, it has proposed the same projection lives for regulatory purposes that it is using for financial reporting purposes.

B&VG argue that depreciation expenses in the past fifteen years were sufficient to correct serious underdepreciation and that current depreciation rates are adequate to allow the RBOCs to fully recover the costs of the investments support-

⁴⁰ *Id.* at 20.

ing basic local services over the useful life of the assets.⁴¹ The study, however, offers no analysis as to what appropriate depreciation lives are. It can therefore offer no basis as to whether there is or is not an underdepreciation issue. The study also offers no analytical evidence as to whether RBOCs can fully recover costs and whether this recovery will actually be in line with the consumption of the companies' assets.

Overall, MCI offers no evidence that today's prescribed depreciation lives and rates accurately reflect the realities of today's telecommunications environment. In assessing what appropriate lives should be, one can look at what the LECs are using for financial reporting purposes. One can also look at the lives that are being prescribed by the Commission for AT&T's plant lives which are for the most part shorter even than the LECs are proposing.⁴²

B. The Commission Is Not Required To Select A TFP Based Only On Interstate Input And Should Not Do So

AT&T and Ad Hoc contend that the Commission is required to select a TFP based solely on interstate inputs.⁴³ This position is neither technically feasible nor legally mandated by prior precedent. In the Fourth FNPRM the Commission determined that interstate and intrastate services are provided largely over common

⁴¹ B&VG Executive Summary at 4.

⁴² See USTA Reply Comments, TFI Attachment at Table 3.

⁴³ AT&T at 14-15; Ad Hoc at 6.